THE NEW BASEL ACCORD: PRIVATE SECTOR PERSPECTIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THE NEW BASEL ACCORD: PRIVATE SECTOR PERSPECTIVES

Tuesday, June 22, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:10 a.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Representatives Bachus, Gillmor, Biggert, Feeney, Hensarling, Garrett, Murphy, Maloney, Moore, Lucas of Kentucy and Frank (ex officio).

Chairman BACHUS. [Presiding.] Good morning. Call to order the Subcommittee on Financial Institutions.

At the end of this week, financial regulators from around the world will release the newly negotiated Basel Capital Accord, or Basel II. This accord has been heavily negotiated over the past several years, and there has been significant progress along the way. However, it is the view of this committee there are still several critical changes that should be made before U.S. financial regulators adopt Basel II.

Today, we will hold a hearing entitled, "The Basel Accord, Private Sector Perspectives." This is the third hearing that the committee has held on the new accord. Prior hearings highlighted disagreements among the Federal financial regulators and led the subcommittee to the markup of H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act, legislation which would mandate development of a unified United States position prior to negotiating at the Bank for International Settlements.

Following subcommittee approval of H.R. 2043 by a vote of 42 to zero, we have witnessed more cooperation among the regulators and increased sensitivity to the opinions and perspectives of all the stakeholders in the negotiations. I hope this cooperation continues and that the Federal regulators work together in the best interest of the United States banking sector, financial industry and the U.S. economy as a whole.

There is broad agreement that the first Basel Accord needed improvement. The global financial banking system has changed significantly since Basel, and the old ways of measuring and managing risk are simply inefficient. What has developed through the Basel II process is state-of-the-art risk assessment and manage-

ment. However, there are significant issues that still need to be addressed before the United States endorses Basel II.

The leadership of the Financial Services Committee submitted a comment letter to the financial regulators raising several concerns with Basel II and the related ANRP. Concerns related to operational risk, the risk weight for commercial real estate loans and the impact this accord will have on competition in consolidation within the financial sector were all issues raised by this committee, and none have been adequately addressed to date, in my opinion.

Under Basel II, banks will be required to take a new mandatory capital charge for operational risk. The new charge will require banks to hold capital against losses resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes losses resulting from failure to comply with the laws as well as prudent ethical standards and contractual obligations as well as litigation risk.

I have heard from several financial institutions that there is no widely accepted way to measure these losses and that efforts to quantify operational risk losses are in the very early stages. I would recommend that the Basel Committee seriously consider not making operational risk charge a mandatory one but rather one that is set on a case-by-case basis by the regulator. Because operational risk is so difficult to define, it makes sense for the regulator to know it when they see it and then set a capital charge as opposed to mandating the charge.

The Federal regulators often claim that the Basel II proposal will continue to evolve and be flexible. If that is true, the case should be an operational risk charge evolved from Pillar 2 treatment to Pillar 1 treatment once it has become easier to measure.

The U.S. commercial real estate market has proven to be strong and is a key drive to our economy. Again, the committee is concerned that, as drafted, Basel II will require a 25 percent risk weight increase for some acquisition development and construction loans. This is highly problematic as it will drive banks out of this type lending, stifling economic growth.

There have been tremendous advances in the assessment of risk for this type of lending. Unfortunately, the Basel Committee is not taking into consideration these important advancements and is applying an unsophisticated standard for the risk associated with this important lending sector.

I am concerned that the real goal here is to improve risk management in Europe, Asia and other parts of the world. However, U.S. lenders will be negatively impacted even though they follow state-of-the-art management techniques in acquisition, development and construction lending.

Competition in markets is key to ensuring that innovation is encouraged, services are available and prices are kept low. The Basel II Accord is going to apply only to the largest financial institutions in the United States. However, there are some institutions that will see compliance as a requirement to remain competitive while others simply will not have the resources or expertise to comply with Basel II.

My concern is that this two-tiered system will, through regulation, force banks to merge, sell or change their business models.

This can mean a reduction in access to financial products and to some increasing costs for consumers, all because of a regulatory regime that was negotiated outside the political process.

Basel II has the potential to radically change the way banking is done in the United States. I understand that the Federal Reserve has issued a white paper on this subject; however, it is my understanding that that white paper looks back at the effect of previous regulatory decisions on industrial consolidation—or industry consolidation, not forward. The fact is that none of the regulators actually knows what effect Basel II will have on the U.S. industry.

I find it troubling that our regulators will be willing to consent to such an agreement before the conduct a fourth impact study, which is scheduled for this fall. Why not get the results of this study before agreeing to Basel II? What is the rush? If we are going to radically change the way banks assess their capital, shouldn't we look at what the impact will be on those institutions before signing on the dotted line?

I want to thank the witnesses for appearing today. We have a diverse panel. I look forward to hearing your perspectives on the Basel II Accord.

At this time, I will recognize Ms. Maloney for any opening statement.

Mrs. MALONEY. I want to thank the chairman, and I agree that this is one of the most important issues before this committee and that we should have the impact study before going forward.

I, first, would like to defer to the chairman of the committee, Mr. Frank.

Mr. FRANK. Well, I wish that that is in fact what you were doing, but you are——

Mrs. MALONEY. Chairman for the Democrats.

Mr. FRANK. Thank you. I think pretender to the chairmanship is probably the actual title at this point.

Chairman BACHUS. I didn't see you down there. I apologize. I did recognize you now that I see you.

Mr. FRANK. I thank you, Mr. Chairman. I am very proud of the work this committee is doing on a bipartisan basis, and I thank the chairman of the subcommittee, the chairman of the full committee, the ranking member of the Subcommittee on Domestic and International Monetary Policy which is really one of the areas which this affects, although it is within the jurisdiction of the Subcommittee on Financial Institutions.

When this whole process started, frankly, we were watching the Federal Reserve simply go forward and do what it wanted to do without a lot of input from anybody else, including the other bank regulators. And this committee and members of this committee were alerted to some problems by a wide range of people in the banking community, let's be clear. We had some of the large institutions that do custodial work who were worried about the operational risk. We have the small bankers who really now have reopened, fortunately, the whole Basel I question and the impact competitively of differential capital requirements.

And we have also, I think, uncovered a floor on America's decision making, because these are very fundamental issues and they were being done not only without any congressional input but real-

ly without input from anybody outside the Fed, the way it had been structured. We found that the Controller of the Currency and the head of the FDIC and head of the OTS all felt that they had been somewhat marginalized in the process, and we now have a genuine process that is going forward, and I appreciate that.

There is one flaw still there, or at least one problem, that makes me less reassured than I am told I should be. People have said, "Well, don't worry because once Basel II is affirmed internationally, it still has to be implemented by each country's own laws." But with regard, certainly, to operational risk, that means the Fed, I assume. I think the entities that would be there would be the Federal reserves. So we know that the Federal Reserve won't simply go forward with it, and that is why it is important for us to focus on it.

I must say that I think we should, once this is put aside, continue to look at the situation. We have a very unsatisfactory situation from the standpoint of good governance as to how America's position is formulated on these major international issues, and I thank the chairman for having moved that legislation, and I am certainly convinced that we should continue our interest in this even after this is resolved one way or the other specific of Basel II.

As to operational risk, I remain convinced that it is a mistake to go forward with it. I think it is a case of doing something that is easy and quantifiable because what really ought to be done looks harder; that is, the management approach is the one that ought to be taken, that this is almost a disconnect in my mind between imposing a capital charge and the risks we are dealing with here.

And I say that when we are talking about capital reserves for loan losses, et cetera, we know what we are talking about. We know a certain percentage of loans are going to go bad, you can deal with that. Operational risk is of course a simple name for a whole host of complex factors—of fraud, of physical damage, et cetera—and it does not seem to me that the analogy works, that the fact that you can put a capital charge for economic losses which over time you can calculate predict, that that translates into a whole bundle of unrelated kinds of specific issues.

It is also the case that the experience, it does not seem to me, that we have had argues for the need for this. We have not had significant problems here which couldn't be handled under the normal rules, and you clearly have the problem of competitive disadvantage, particularly since we are talking here, by definition, about international activities. It is Basel II recognizing the international nature of this. So I believe that the case fails, as I have seen it, for a capital charge for operational risk, and I am concerned about the negative implications—the negative effect that will have.

I also want to hear more about the argument that was raised by various of the smaller banks and confirmed by the chairman of the Federal Deposit Insurance Corporation, Mr. Powell, about the competitive disadvantage. Now, maybe the view is that we won't have to worry about that in 10 years because there won't be any small banks. We read about Wachovia now, we have read about B of A, we have read about Bank One and JPMorgan Chase. I mean when

I came here this used to be called the Committee on Banking, Financial and Urban Affairs. We have now changed it to Financial Services. If we were to take back the House, we might go back to the old rule, because unlike our colleagues, we don't think Urban Affairs is like a bad word, so we would put it back in the title. But if we did go back, depending on when, we might have to change it. Instead of it being the Committee on Banking, Financial and Urban Affairs, in a few years it might be the Committee on the Bank, Finance and Urban Affairs, because I am not sure there will be more than a couple.

But for as long as we do have small banks, they ought not to be at a competitive disadvantage. And, obviously, we believe there should continue to be small banks. They play a very important role. I will say I have had some good relations with the larger banks that have merged in my area. It has also been the case that when those merges have taken place, the small borrowers, the local retailers, the local home builders have said to me that they thought it was important that some local banks also be around, because they have found that this is their preference for dealing with them.

So preserving the ability of the community banks, the local banks to perform their function is very important. It is not in competition with the others; they have different niches, it seems to me. But that issue also, I think, still is unresolved, and I am grateful to those who have brought it to our attention.

So with that, Mr. Chairman, I appreciate your convening this hearing again, and I hope that we will get some understanding on the part of the executive branch, particularly people at the Federal Reserve, that it would be a mistake—let me say, finally, it would be a mistake for them to go ahead simply because they have the legal authority to do it in the face of a significant lack of consensus. That is not a good way to run regulatory affairs. You can't simply do that by fiat, and I think it is clear from this ongoing process we are not yet at the point of consensus that ought to precede a decision of this magnitude.

Mrs. MALONEY. Thank you very much. In the interest of time, I would like to put my opening remarks in the record, but I would just like to note my appreciation of the bipartisan leadership on oversight on this important issue. And as we all know, the discussions are now reaching a very critical stage where key issues must be hammered out and not just at a theoretical level but at a nuts and bolts level of detail that will really determine how the new accord will affect the financial services sector in the United States.

And because the new accord will affect financial institutions differently, depending on their size and portfolio, we have asked a large spectrum of banks and others to attend and provide their view today. And our goal must be to encourage a fair, competitive field for U.S. institutions in the global market so that our institutions are not disadvantaged in any way in requiring higher capital standards or so forth. But we are also very concerned that banks within the United States are not unfairly disadvantaged or that one bank is not unfairly advantaged over another because of the type or the size.

So we have asked each of you to address these points in your testimony and of course to offer any other points that you may have.

As you may know, based on our concern on this important issue, Chairman Bachus as well as Mr. Oxley and Mr. Frank and myself, we have put forward and have introduced legislation requiring U.S. legislators to develop uniform positions in the negotiations and to report to Congress on any proposed recommendations of the Basel Committee before agreeing to it.

Regrettably, our legislation did not pass, but I believe that our concern demonstrated—our legislation demonstrated our serious concern and played an important part in advancing the many hearings that we have had and the negotiations we have seen today.

I join Ranking Member Frank and Chairman Bachus in really urging that the report at least be completed and reviewed by Congress before going forward and that no other consensus be reached before making any international agreements that will be binding on American institutions, on their safety and soundness, their ability to compete here and the foreign markets.

So I look forward to the contributions of the committee today, of the witnesses today, and I thank them for being here.

Chairman BACHUS. You are going to yield back the remainder of your time? Okay.

At this time, I know that Ms. Biggert and Mr. Murphy are going to introduce two of our witnesses, but, Mrs. Biggert, do you have an opening statement?

Mrs. BIGGERT. I don't.

Chairman BACHUS. Mr. Murphy, Mr. Hensarling, any opening statements?

Mr. Moore, do you have an opening statement?

Mr. MOORE. No, I don't.

Chairman BACHUS. All right.

Mr. Lucas? Okay.

If there are no other opening statements, we will introduce our first panel, in fact our only panel. So you all could be our last panel too. Our first witness is Mr. Steven G. Elliott, and I am going to recognize Mr. Murphy, the gentleman from Pennsylvania, to introduce Mr. Elliott.

Mr. MURPHY. Thank you, Mr. Chairman. Mr. Elliott is here by popular demand in a return engagement. He is senior vice chairman of Mellon Financial Corporation where he is responsible for the corporation's Asset Servicing, Human Resources and Investor Solutions. The corporation's Finance, Treasury, Technology, Corporate Operations and Real Estate and its Venture Capital Businesses also report to him.

His travels have taken him around the country with various positions, everything from a degree from University of Houston and business administration from Northwestern, he is also worked with Crocker National Bank and Continental Illinois National Bank and First Interstate Bank of California, so I would say most of the States have probably seen his hand in his abilities.

Mellon manages $3.6 trillion in assets under management, administration or custody, and so his skills and knowledge of these issues runs deep, and we are delighted to have him here.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Murphy.

We welcome you, Mr. Elliott, to the committee.

Our next witness is Adam Gilbert. Mr. Gilbert is managing director of JPMorgan Chase. He is currently the chief operation officer for the Credit Portfolio Group, which is mandated to actively manage the firm's retained risk resulting from failed loan commitments and counterparty exposures.

In addition, Mr. Gilbert leads firm-wide efforts on various public policy and industry issues, including revision of the Basel Capital Accord and advises business and corporate functions on supervisory and regulatory matters. He was a member of the Corporate Treasury Group where he oversaw the development of economic capital and transfer pricing policies and supported the firm's Capital Committee.

He began his career in 1987 at the Federal Reserve Bank of New York where for over 10 years he held positions in the Bank Supervisory Group, Credit and Discount Department and Research and Market Analysis Group. Interestingly enough, among other things, he spent two and a half years in Basel, Switzerland as a member of the secretariat of the Basel Committee on Banking Supervision.

He graduated a Master's degree from Harvard University's John F. Kennedy School of Government and Bachelor of Arts from Tufts University where he graduated Summa Cum Laude and Phi Beta Kappa. Is that a fraternity, Summa Cum Laude? No. All right.

I hope you all know I am kidding.

[Laughter.]

When I campaign in some counties I say that is a fraternity.

Our next witness—we welcome you, Mr. Gilbert. Our next witness is Joseph Dewhirst—Dewhirst, I am sorry. And Mr. Dewhirst is corporate treasurer at Bank of America. He is a member of the Management Operation Committee and Assets Liability Committee. He is responsible for managing corporate and bank liquidity and capital positions. He is also responsible for managing corporate insurance, economics and certain aspects of the management of corporate pensions and 401(k) accounts.

He joined Bank of America as corporate treasurer just, what, two months ago? Coming from Fleet Boston Financial where he had been corporate treasurer. So you were merged into the Bank of America.

Mr. DEWHIRST. That is right.

Chairman BACHUS. And he graduated also Harvard University—I mean Harvard College, Harvard University in 1973 where he majored in psychology and social relations, earned a doctorate in social psychology from Harvard University in 1978. For the past 16 years, Mr. Dewhirst has coached youth soccer in Sharon, Massachusetts and served on the Board of the Sharon Soccer Association. For two years, he served as president of the association. I appreciate that.

Our next witness is Ms. Kathleen Marinangel, and I am going to recognize Ms. Biggert from Illinois to introduce Ms. Marinangel.

Mrs. BIGGERT. Thank you very much, Mr. Chairman. I am very happy to welcome Kathleen Marinangel to the panel today. There is an old adage that, "Ask a busy person to do the job, and they get the job done." I think this certainly applies to Ms. Marinangel. She is not only the CEO and president of McHenry Savings Bank but also the chairman of the board of directors, and she serves on

the board of the American Community Bankers, which she is representing today and serves on the Basel II Working Group Committee, along with many other committees.

She also is on the board of directors of the Illinois League of Financial Institutions, Thrift Association's Advisory Council, board of the directors of the Federal Home Loan Bank of Chicago, Illinois Board of Savings Institutions where she was appointed by the governor and serves to the president, American Council of State Savings Supervisors, along with another list.

She also has her pilot's license and community involvement at Suntraga Board of Governors, City of McHenry Economic Development Commission, McHenry Area Chamber of Commerce, along with many others. I would like to welcome her here today.

Chairman BACHUS. Thank you very much. Our next witness is—and welcome you, Ms. Marinangel to the committee.

Our next witness is Ms. Sandra Jansky, SunTrust Banks. She is executive vice president and chief credit officer. In this role, she oversees the company's credit-related functions, including credit policy, credit administration, credit and capital market risk, special assets, credit review, credit risk portfolio metrics and wholesale bank credit services. She has extensive commercial banking experience, including corporate and investment banking.

She began her career at First Union National Bank, served there until 1981 when she joined SunTrust. She attended the University of North Carolina, graduated from the Louisiana State University Banking School of the South. She serves as executive committee member of the International Board of Risk Management Association and is immediate past chair. She is former chairman and board member of the Foundation for the Orange Public Schools in Orlando, Florida as well as various other civic organizations. So we appreciate your service on behalf of public schools there in Orlando, Florida and welcome you to the committee.

Our final witness is Michael Alix. Mr. Alix is with Bear Stearns. He currently chairs the Security Industry Association's Risk Management Committee, and he will be testifying on behalf of Security Industry Association. He is senior manager and director and head of Bear Stearns Global Credit Organization. As such, he is responsible for overseeing independent counterparty credit risk management with focus on the firm's global fixed income and equity businesses. He chairs the firm's Credit Policy Committee and serves on its Risk, Operations and Principal Activities Committees. He is also active in the Bond Marketing Association.

Prior to joining Bear Stearns, he held a variety of credit risk management positions at Merrill Lynch, including a Tokyo-based head of Asia Credit. Holds a B.A. in economics from Duke University and an MBA in Finance from the Wharton School of the University of Pennsylvania. We welcome you, Mr. Alix, to the committee.

With the introduction of all the first panel, we will proceed to opening statements. We are going to start with Mr. Elliott and proceed through to Mr. Alix.

So at this time, I will recognize you, Mr. Elliott, for an opening statement.

STATEMENT OF STEVEN G. ELLIOTT, SENIOR VICE CHAIRMAN, MELLON FINANCIAL CORPORATION

Mr. ELLIOTT. Thank you, Mr. Chairman. My name is Steve Elliott, and I am senior vice chairman of Mellon Financial Corporation, a leading global provider of financial services that has been serving its customers for more than 130 years. Headquartered in Pittsburgh, we are a specialized financial institution, providing institutional asset management, mutual funds, private wealth management, asset servicing, human resources and investor solutions and treasury payment services. Mellon has approximately $3.6 trillion in assets in our management, administration or custody, including more than $675 billion under management.

It is a pleasure to testify today before the subcommittee on the potential impact of Basel II on Mellon Financial Corporation and, more broadly, on the ability of U.S. banks to serve their customers and investors. It was an honor also to appear last June before this panel on this topic.

I am grateful for Congress' continued interest in the Basel Accord. Your focus on this sometimes overwhelming technical rule has ensured attention by regulators at home and abroad on what the changes to the international risk-based capital rules mean on the most important level: The ability of individual and corporate customers to get what they need at a competitive price from a vibrant U.S. financial services industry.

As a specialized financial institution serving pension plans and the securities industry, Mellon has a special concern with a particular aspect of the Basel II proposal: The new regulatory capital charge for operational risk. We think much in the proposed new international capital standards and low regulations plan to implement them are quite good. Indeed, the current risk-based capital standards need wholesale rewrite. However, the overall need for new capital standards should not distract from the critical importance of getting the details right.

The operational risk charge could well have a dramatic and adverse competitive impact on specialized banks. Trillion dollar diversified banks can offer a broader range of services to their customers; however, that is often done at a cost: The inability to focus clearly on individual clients who want a high degree of expertise and service in areas like asset management and payment processing.

Mellon is grateful to you, Chairman Bachus, and the leadership of this subcommittee, along with that of the Financial Services Committee under Chairman Oxley and Ranking Member Frank, for your continued attention to the many problems with the operational risk charge, particularly its potential adverse competitive impact.

You have rightly pressed the Federal Reserve to analyze the Accord's competitive impact. We understand the board is currently studying the operational risk-based capital charges competitive impact. Mellon is of course happy to cooperate in any way that would help in bringing about the right result.

The board has completed a study on the rule's impact on mergers and acquisitions—a key question to ensure that the Nation's banking system does not become too consolidated. I would argue that

there is a direct correlation between capital and business activity, that if there wasn't, it would be hard to understand why all of the U.S. and international banking agencies have devoted so many years of hard work to the Basel II rewrite. This is far from a technical exercise but rather one of profound implications.

Today, I would like to emphasize the need for the Basel rules and, especially the U.S. version, to rely upon effective prudential regulation and enforcement to address operational risk. An arbitrary regulatory capital charge for operational risk, like the one now proposed, will have an adverse market consequences that will ultimately undermine our customer service.

The risk posed by the operational risk capital charge, even in the advanced version proposed in the U.S. We continue to believe that the ongoing improvements to operational risk management will be undermined by the proposed capital charge, creating perverse incentives for increased operational risk, not the decrease that regulators desire and on which Congress should insist.

And the importance of other changes to the U.S. version of Basel II to ensure that our banks remain competitive and focused on key market needs. This means a review of the complex credit risk standards for specialized banks. A hard look at the proposed retention of a leverage standard and the criteria for determining who is a well-capitalized bank is also vital, since these standards only govern U. S. banks and could have an adverse competitive impact if retained.

Mellon respects the desire of the Federal regulatory agencies in Basel and the U.S. to advance operational risk management. That is why the Financial Guardian Group, to which Mellon belongs, has answered the U.S. regulators' request for a detailed and enforceable safety-and-soundness standard with a comprehensive proposal. I have attached that proposal to this statement for your consideration.

The U.S. regulators also have asked us for a safety-and-soundness approach, called Pillar 2 in the Basel framework, to be paired with an improved disclosure, Pillar 3, to back up regulatory enforcement with market discipline. We took that request very seriously and provided a detailed proposal which I have also attached to my statement. The Federal Reserve Board thanked us for our submission but does not appear to be pursuing it as an option. However, we are still hopeful that a compromise can be reached.

Thank you, and I will be pleased to answer any of your questions.

[The prepared statement of Steven G. Elliott can be found on page 69 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Gilbert?

STATEMENT OF ADAM GILBERT, MANAGING DIRECTOR, GLOBAL CREDIT RISK MANAGEMENT, JPMORGAN CHASE & CO.

Mr. GILBERT. Good morning, Chairman Bachus, Congressman Sanders and members of the subcommittee. My name is Adam Gilbert, managing director in the Credit Portfolio Group at JPMorgan Chase & Co. JPMorgan Chase is a U.S.-based internationally active bank operating in more than 50 countries. We are currently in

the process of merging with Bank One, the Nation's sixth-largest bank holding company. Thank you for inviting me here to discuss the proposed revisions to the 1988 Basel Capital Accord, more commonly referred to as Basel II.

We commend the committee's continued interest in Basel, which has been beneficial to the process and appreciate the unique opportunity to have a constructive dialogue concerning what we expect will be an improved framework for regulatory capital requirements. We also commend the Basel Committee, the US regulators and U.S. financial institutions for the openness of the process and their role in developing the proposals.

Although there are a number of areas requiring further consideration, the proposals to date do a far better job of measuring risk than the rules they are intended to replace. Please allow me to begin with a summary of our views and conclude with areas we suggest warrant further review.

We strongly support the direction of Basel II. The three pillars of minimum capital requirements, Pillar 1, supervisory review of capital adequacy, Pillar 2, and market discipline, Pillar 3, provide a solid framework in which to address safety and soundness issues in an environment of continuous innovation in the financial markets.

The committee's objectives with respect to Pillar 1 capital requirements, that is improving the way regulatory capital requirements reflect the underlying risks and incorporating advances in credit and operational risk measurement techniques, will address deficiencies related to the current regime and have the potential to promote stronger practices at internationally active banks. Today's capital rules treat all borrowers the same regardless of credit quality and do not address operational risk explicitly. Basel II will correct this.

Ultimately, a bank's risk profile is best measured using its full range of internal models. As an important step in that direction, we welcome the advanced internal ratings approach, which will permit banks to incorporate their own estimates of default and loss recovery rates into a formula calibrated by supervisors. We also welcome the advanced measurement approach for operational risk which directly leverages banks' risk measurement techniques.

There has been considerable debate about the appropriateness of a Pillar 1 capital charge for operational risk. We are highly supportive of a Pillar 1 approach rather than a Pillar 2 approach, as some have suggested. A Pillar 2 approach would require banks to gather essentially the same information as if they had a Pillar 1 charge, yet there likely would be a loss of transparency and consistency in the methodology applied across the global industry.

For about a year now, we have had an internal operational risk capital charge in place which we believe is consistent with the AMA standards. We have this charge because we are fully cognizant that inadequate or failed systems, processes or people can result in losses to our firm. The information and control processes associated with our capital framework have already provided significant value to our business and risk managers.

The science around operational risk measurement will continue to evolve, no doubt, but we believe that an explicit Pillar 1 charge

and associated standards will be beneficial in this regard and will promote further discipline in banks' operations.

In a few days, the Basel Committee will release a revised version of its capital accord, reflecting comments from across the financial services industry. The new version of Basel II will incorporate positive changes related to the calibration of the overall capital requirement, the measurement of credit risk for wholesale and consumer businesses as well as guidance on the practical application of the AMA.

We appreciate the fact that the Basel Committee has committed to continue work on several important areas that we believe necessitate further enhancements. These areas include the treatment of counterparty credit risk, hedges of credit risk and short-term exposures. There are several other issues which merit clarification and modification, but these are largely technical in nature. Additional information can be found in our recent comment letters or I would be happy to discuss these in greater detail during the Q&A.

To be sure, there is a lot for both banks and supervisors to do to prepare for the implementation of Basel II. A primary example is the qualifying process for the advanced approaches, which will be very burdensome unless there is close cooperation among supervisors. Home countries' supervisors must play the lead role to ensure that the process for qualifying is addressed at the consolidated level and that banks do not have to go through separate approval processes in every country in which they have a presence.

We understand that some local requirements might be different for subsidiaries and possibly branches, but we expect the home supervisor to help bridge the gaps when necessary. We are confident the U.S. supervisors will do just that.

Chairman, I would like to thank you and the committee for the opportunity to speak on these issues. This concludes my remarks today, and I would be happy to answer any questions you might have.

[The prepared statement of Adam M. Gilbert can be found on page 78 in the appendix.]

Chairman BACHUS. Thank you, Mr. Gilbert. And before I recognize Mr. Dewhirst, I did want to say that, without objection, your entire written statements will be made a part of the record.

At this time, Mr. Dewhirst, you are recognized for an opening statement.

STATEMENT OF JOSEPH DEWHIRST, TREASURER, BANK OF AMERICA CORPORATION

Mr. DEWHIRST. Chairman Bachus, members of the Subcommittee, on behalf of Bank of America, I would like to thank you for this opportunity to provide our comments regarding the Basel II framework. I am Joseph Dewhirst, and I am the corporate treasurer of Bank of America.

Let me begin by summarizing Bank of America's position on Basel II. First, the overriding concern of bank regulators is the safety and soundness of the banking industry, and, of course, we share this concern. Capital is a buffer against loss, and it seems sensible to us that bank management and bank regulators assess the adequacy of bank capital by looking at risk of loss.

Bank regulators worldwide used Basel I to formalize the view that capital allocation should be risk-based. This capital accord was, in our view, a major step forward in rationalizing the assessment of the capital adequacy of banks. But Basel I was, nevertheless, only an initial step.

As the industry has developed more sophisticated methods for measuring risk, often dependent on computing power that has become available only during the last decade, there has been a growing need for more advanced regulatory capital requirements, and Basel II is that more advanced approach. So we strongly support the Basel initiative to better align regulatory capital requirements with underlying economic risks.

Next, let me give a brief assessment of the progress made. Our general view is very positive. Significant progress has been made, and we commend the agency's leadership in this process. While time-consuming and sometimes contentious, the consultative dialogue maintained with the industry has improved the transparency of the process and the quality of the results.

There are, nevertheless, several technical issues that still cause us concern, and we summarized some of these issues in a technical appendix; but we have every confidence that these issues will be resolved before the final implementation date.

Some have raised questions about operational risk. Bank of America strongly supports the Pillar 1 capital requirements for operational risk, because it aligns the regulatory capital requirements with industry best practice. Recent history provides ample evidence that operational risk can be significant, and it deserves the same rigor of analysis that is employed for credit and market risk.

Bank of America has already implemented explicit capital charges for operational risk within its own internal systems. We believe these models are almost fully compliant with the AMA requirements, and it would be disingenuous for us to take any position other than supporting the Pillar 1 approach.

Let me turn next to the competitive environment. We believe that changes in capital requirements will not materially alter the competitive landscape. In particular, well-managed banks will not see significant change. To the extent that change does occur, it will follow from more prudent management of risk and more rational allocation of capital.

Bank of America believes that good risk management provides a competitive advantage, irrespective of the regulatory capital framework. Therefore, we have invested significant time and resources to develop industry leading risk management processes and economic capital models.

Correspondingly, Bank of America already manages its business activities on the basis of risk-based capital. We believe that these tools enable us to make better risk and return decisions. Since we already manage based on methods broadly consistent with Basel II, our behavior is not likely to change in any material way.

Concerns have been raised regarding the prospects for industry consolidation as a result of Basel II. Of course, there are economies of scale in risk management. So at the margin, by encouraging good risk management, Basel II may encourage consolidation. But

it will be insignificant compared to other drivers of consolidation, such as the economies of scale around product development, systems and staffing as well as the benefits of diversification across business and geography.

As indicated, we have a number of technical concerns. Under Pillar I, work remains to be done on a calibration of capital for mortgages and other retail assets. The current approach assumes that there is inherently more risk in these assets than seems justified. Under Pillar 2, we have concerns about implementation of rules to create a level playing field internationally. And under Pillar 3, we think that the disclosure requirements of the standard are still excessive.

As I said, we provide details regarding these and other concerns in the attached appendix, and I would be happy to answer questions.

In closing, let me again assure you that we strongly support the objectives of Basel II, and we have been pleased both with the process and progress to date. While we acknowledge and recognize outstanding issues, we believe these issues can be resolved satisfactorily. Finally, we believe that Basel II will encourage better management of risk and more rational allocation of capital within the banking industry. Thank you.

[The prepared statement of Joseph Dewhirst can be found on page 60 in the appendix.]

Chairman BACHUS. Thank you, Mr. Dewhirst.

Ms. Marinangel?

STATEMENT OF KATHLEEN MARINANGEL, CHAIRMAN, PRESIDENT & CEO, MCHENRY SAVINGS BANK, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Ms. MARINANGEL. Mr. Chairman, Ranking Member Sanders, and members of the subcommittee, my name is Kathy Marinangel. I am chairman, president and chief executive officer of McHenry Savings Bank, a $210 million institution in McHenry, Illinois. I appear today on behalf of America's Community Bankers, where I serve as a member of the board. Thank you for this opportunity to testify on the impact that the Basel II Accord will have on community banks.

I believe that the development and implementation of the Basel II Accord will present one of the most significant threats to community banks today, unless it is balanced by a carefully revised Basel I Accord.

Since the adoption of the Basel I in 1988, the ability of all financial institutions to measure risk more accurately has improved exponentially. Community banks desire to adopt a more risk-based sensitive model, such as Basel II. Unfortunately, the complexity and cost of implementation of the Basel II models will preclude most community banks from taking advantage of the positive benefits.

I think the resultant disparity that will be created between banks is totally wrong. Under the current proposal, my institution would remain subject to Basel I. If it were economically feasible, my bank would prefer to opt in to Basel II. In fact ACB believes

that any financial institution that has the resources should be able to opt in to Basel II.

While there are a number or risks involved in determining risk-based capital, an important one is interest rate risk, which Basel I has generally failed to address for most community banks. After barely surviving the high interest rate cycle of the late 1970s and early 1980s, McHenry Savings Bank adopted a strategic plan that included a goal to diversify assets in such a way that the bank would never again rely on one type of asset in its loan portfolio so that we could better manage interest rate risk.

An important factor in this strategy was the ability to reprice as many assets as often as possible. We believe that flexibility and repricing is a key to survival in times of fluctuating interest rates. For several years, McHenry Savings Bank has repriced 80 percent of its assets annually.

Shortly after completing the restructuring of our portfolio, in 1988, Basel I was implemented. Unfortunately, the simplicity of the formula did not enable a determination of the true risk of assets. Little or no consideration was given to collateral value or loan to value of these assets. Thus, Basel I has forced us to give up an asset mix that would reprice frequently, something that we would want now in a rising rate interest rate cycle. New options under Basel I are essential.

ACB supports the efforts of U.S. and global bank supervisors to more closely link minimum capital requirements with an institution's true risk profile. This approach could improve the safety and soundness of the banking industry and allow institutions to deploy capital more efficiently. However, a bifurcated system will open the door to competitive inequities.

Two banks, a larger Basel II bank and a small Basel I community bank, like mine, could review the same mortgage loan application that presents the same level of credit risk. However, the larger bank would have to hold significantly less capital than the small bank if it makes that loan, even though the loan would be no more or no less risky than if a community bank made that loan, assuming the large bank adopts Basel II.

Capital requirements should be a function of risks taken, and if two banks make similar loans, they should have a very similar required capital charge. ACB is concerned that unless Basel I is revised, smaller institutions will become takeover targets for institutions that can deploy capital more efficiently under Basel II. As community banks disappear, the customers will lose the kind of personalized service and local decision making they want.

If Basel II is implemented for a portion of the banking industry, changes must be made at the same time to Basel I to maintain similar capital requirements for similar risk. For example, I have developed a formula in appendix A that includes more baskets and a breakdown of particular assets into multiple baskets when taking into consideration collateral values, loan-to-value ratios and other factors.

Whatever refinements are made, community banks must retain the option to leverage their capital regardless of the complexity of the calculations. Community banks must be given the opportunity to compete against the international banking giants who, by the

way, have branches in my town and many other towns across America.

We thank Chairman Bachus and the rest of the subcommittee members for holding this hearing. As I mentioned at the outset, there is no more important issue to community banks today than the proper implementation of Basel II and the sensible revision of Basel I. Thank you.

[The prepared statement of Kathleen Marinangel can be found on page 90 in the appendix.]

Chairman BACHUS. Thank you, Ms. Marinangel.

Ms. Jansky, I welcome your testimony.

STATEMENT OF SANDRA JANSKY, EXECUTIVE VICE PRESIDENT & CHIEF CREDIT OFFICER, SUNTRUST BANKS, INC.

Ms. JANSKY. Mr. Chairman and members of the committee, I am very pleased to have the opportunity to discuss SunTrust's view of the proposed capital accord. I am Sandra Jansky, executive vice president and chief credit officer for the company.

SunTrust is the seventh largest domestic bank in the United States. We have 1,201 offices located in 11 states, with 27,000 employees.

In my comments today, I will address our reasons for choosing to become an opt-in bank, that is voluntary compliance—I understand that has a different meaning in Washington—but is a volunteer bank, and also discuss the issues that we believe continue to be problematic.

Our financial institution believes that it is imperative for us to comply with the provisions of Basel II. As a conservative risk taker, we believe we have been required to hold excessive regulatory capital without true consideration for the composition of the risk in our institution. If there is an opportunity to better align regulatory capital with economic capital, we want to be able to qualify for such treatment.

We believe we have to move forward quickly to meet these requirements under the accord due to our current size. By the end of September 30 of this year, we will have approximately $145 billion in assets. Due to the complexity and the vast requirements recommended under the accord, it is impractical for our institution to delay compliance with the proposal. We believe delays would further add to the cost of implementation and cost of compliance.

We also believe that we would be at a competitive disadvantage compared to the core banks if they are able to operate with lower capital levels than our institution. We have considered voluntary compliance because it has made our effort to try to work towards a better alignment more important to the institution. As an opt-in bank, we have issues in meeting the accord requirements, primarily because we are not at the table with the core banks and the regulators when key issues are explored and recommendations are made on a wide variety of issues.

Core banks have the advantage of more focused regulatory assistance as they pursue the advanced internal ratings-based status. Volunteer banks need additional guidance and assistance from the regulators that frankly is not currently available.

I have outlined in our testimony some of the benefits that SunTrust has seen from beginning the implementation of the Basel II Accord, primarily our risk rating system. As much as we like certain aspects of the accord, we do believe the overly prescriptive requirements as well as the level of complexity will continue to challenge us as we move towards advanced internal ratings-based status.

We continue to remain concerned about the special treatment provisions required for certain specialized lending areas, such as commercial real estate. While some change has been announced to the original proposal, we believe that the higher capital requirements for certain asset types without regard to the specific risk management practices of a particular institution or the performance of those assets over time is problematic.

We are also concerned about the correlation requirements for residential real estate and home equity lines and loans versus credit card products that we understand are in the accord. The proposed treatment will impact the cost of credit availability to certain product lines that have grown tremendously over the last 10 years. The correlation requirements proposed could result in higher capital to secured equity products than unsecured credit card products. Our actual experience in these products over a significant period of time indicates the losses have been significantly below those minimum requirements.

Of all the changes required for advanced status under Basel II, the most significant for us is the quantification of operational risk. The Federal Reserve has taken the position that the advance measurement approach is the only acceptable approach to calculating operational risk regulatory capital and is therefore required if a bank wants to use the advanced internal ratings-based approach to credit capital. We believe this might place certain banks in the American banking industry at a competitive disadvantage.

If SunTrust can satisfy the requirements for the advanced internal ratings-based approach for credit risk and we fail to meet some of the unspecified requirements for the advanced measurement approach for operational risk, we will be forced to continue with the current accord. A similar bank in another country would have the ability to use the AIRB approach for credit risk and the basic or standardized approach for operational risk.

Finally, we have outlined some issues with the disclosure requirements in my testimony. Primarily, we believe they will add additional pages of information, highly technical, that will be of little value to a vast majority of the readers.

SunTrust believes the new accord is a very positive step in the right direction. We would like to see the regulators establish a working group of the opt-in banks to further enhance our ability to meet the requirements under the accord. We also would request that the U.S. regulators consider allowing banks to qualify for the advanced internal ratings-based capital approach for credit risk, while considering the standardized or basic approach for an interim period of time. We also believe the asset correlations, as I mentioned earlier, need to be addressed.

Thank you, Mr. Chairman.

[The prepared statement of Sandra W. Jansky can be found on page 81 in the appendix.]

Chairman BACHUS. Thank you, Ms. Jansky.

Mr. Alix?

STATEMENT OF MICHAEL ALIX, SENIOR MANAGING DIRECTOR, GLOBAL HEAD OF CREDIT RISK MANAGEMENT, BEAR STEARNS, ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. ALIX. Thank you, Mr. Chairman and members of the subcommittee. I am Michael Alix, senior managing director of Bear Stearns and Company and global head of Credit Risk Management. I am also chairman of the Securities Industry Association's Risk Management Committee. I appreciate the opportunity to testify on behalf of a group of those members of SIA, including Bear Stearns, which are likely to be applicants under the Security and Exchange Commission's new regulatory regime for global consolidated supervision, otherwise known as CSE.

My testimony today comes from the somewhat new perspective of an investment bank viewing Basel II through the prism of the CSE framework. I wish to make the following points. First, in order for U.S. investment banks to compete on a level playing field in Europe, we need to know now If the EU deems the SEC program for consolidated supervision equivalent.

Second, regulators must coordinate and cooperate with counterparts around the globe to ensure smooth implementation of Basel II to avoid excessive costs and duplication of effort that could impose undue burden on firms.

Finally, in order to ensure competitive equality, both banking and securities regulators must address certain remaining technical issues with the risk-based capital calculations required under Basel II.

Let me say a few words about how we got to this point. Major U.S. investment banks are likely to be subject to the Basel Accord, including its risk-based capital standards under the SEC's recently released consolidated supervision program. One key driver of CSE is the requirement by the European Union that firms operating in Europe are subject to comprehensive consolidated supervision. That is why we care about Basel.

The day-to-day experience with Basel I and the leading role of their banking regulators was a key reason why commercial banks were involved closely in the development of Basel II. The major investment banks and securities supervisors were, by comparison, late to the table with respect to key policy discussions with the framers of Basel II.

Initially, investment banks observed that the apparent Basel II capital requirements for some of their key businesses were out of line with perceived risk and actual loss experience. I can report that firms have made significant progress in the last year, clarifying how the calculations should be made and conveying important technical flaws in the accord through direct, constructive discussions with Basel Committee members.

Detailed technical discussions with officials of the Federal Reserve and the SEC enabled four large investment banks to refine

their calculations and complete a quantitative impact study that informed our comments on the Federal Reserve Board's advanced notice of proposed rulemaking.

The recent formation of a task force by the Basel Committee and global securities regulators to follow up on many of our concerns provides important evidence that the Basel Committee takes seriously the unique perspective of the investment banks.

Now, for the remaining steps. First, and most importantly, it is essential that we obtain an EU determination that the CSE is equivalent. Originally, the guidance was to be announced by the end of April this year with the first set of equivalence judgments by June. These time tables have slipped, and we ask that you and your colleagues on the full committee monitor this situation carefully. It is our judgment that there should be no doubt that CSE is equivalent.

Second, it is essential that all regulators coordinate and cooperate with their counterparts around the globe on implementing Basel II. Doing so will permit regulators to leverage their resources, help ensure that no entity is subject to duplicative or inconsistent requirements, and help ensure that supervisory responsibility is lodged with the regulator best situated to exercise such responsibility.

Flexibility in the application of the Basel standards under CSE will be very important. U.S. securities firms have not been subject to Basel standards on a firm-wide basis and thus have not been obligated to build a global Basel I infrastructure. Since banks will have until as late as 2008 to implement the more advanced Basel II approaches, flexibility is necessary for CSE applicants to avoid the undue expense and burden of requiring implementation of a standard destined to be superseded in the near future. In other words, if you decided to build a new baseball stadium in the District in, say, two years, you should not have to pay to renovate RFK right now.

The collaborative process must continue for international capital standards to more fairly reflect the risks inherent in the investment banking business, without imposing large and unnecessary costs. Perhaps most significant among many still open items is whether the SEC and other global regulators will recognize the reality that much of our risk taking relates to trading, rather than banking, activities that meet both the spirit and the letter of the Basel Committee's definition of a trading book.

Banks and securities firms operate and report under substantially different accounting frameworks. Banks generally carry risk assets at cost, accrue earnings, and establish formula reserves. In contrast, securities firms mark to market and treat virtually all business lines as part of a trading book. If in the application of Basel II to investment banks regulators require investment banks to compute capital requirements for trading activities as though they are part of a banking book, investment banks would be taking a double hit in the computation of their requirements.

We very much appreciate the subcommittee's interest in the adoption and implementation of Basel II. We look forward to working with Congress, the administration and the regulators on final-

izing and implementing a new capital accord. Thank you very much.

[The prepared statement of Michael J. Alix can be found on page 46 in the appendix.]

Chairman BACHUS. Thank you, Mr. Alix.

At this time, I recognize Mrs. Biggert for any questions that you have for five minutes.

Mrs. BIGGERT. Thank you very much, Mr. Chairman. This is a question I think that probably all of you could answer, because there seems to be a difference of opinion in what type of bank or institution you have. And that is what effect does the regulatory capital have on your pricing and lending decisions? And does the regulatory capital play a more important role in the management of a community bank than it does for a large financial institution?

I think I will start with Ms. Marinangel.

Ms. MARINANGEL. The second part of the question was does the——

Mrs. BIGGERT. Does regulatory capital play a more important role in the management of a community bank than it does for a large financial institution?

Ms. MARINANGEL. I think the roles are similar. Currently, we are all under the same regulations, and the mix of the portfolio you have to live by the risk-based capital levels is the same to maintain a well-capitalized bank.

Recently, for example, I have had to sell some very well-collateralized commercial loans off to some of my competitors. We have kind of coordinated in that. But to maintain the well-capitalized level, my opinion is that maintaining mortgage loans on your balance sheet, which are 50 percent weighted, now will cause—even though it is a good credit risk, will cause interest rate risk problems as interest rates rise. And, therefore, I feel that the formula has caused problems for a rising rates scenario, and I am sure it is similar for both community banks and the larger banks.

Mrs. BIGGERT. Well, it is my understanding that at least in the areas of small business and mortgage lending, that the advanced approach of Basel II will likely result in significant reductions in the required capital. And if this assumption is correct, do you think that Basel II will make it more difficult for small banks to compete?

Ms. MARINANGEL. Absolutely. I think that deploying capital more efficiently and leveraging capital which will result from the Basel II banks being able to opt in will cause community banks to not be able to compete as effectively. The pricing of the products, as you stated, when you utilize your capital more efficiently, you can price some products at a lower price for the consumer and make it up in other areas. And the larger banks, some of them, offer credit cards and other products that the community banks can't necessarily offer at an efficient level. Therefore, it will make it extremely difficult for us to compete if we are not able to opt in to Basel II or have a revised I.

Mrs. BIGGERT. Okay. And I believe that the banking regulators have recently announced they will consider revising Basel I?

Ms. MARINANGEL. Yes. They have mentioned that they would take it under consideration, and there would be two approaches.

Some community banks may not want to adopt the more advanced Basel I, so they could be left as is or my example that was attached shows more buckets are fairly easily administered, but there could be also a more risk-sensitive approach that is not as complex as the Basel II. And where additional risk for complex and sophisticated products could be added in, could be a Basel 1.5 and less complex.

Mrs. BIGGERT. I think you have the alternative proposal in your testimony. Have you shared this with the banking regulators?

Ms. MARINANGEL. Yes. I have sent thousands of letters over the years, but most recently in November, when the comment letter was due, I sent 1,000 letters out to those banks that had less than 11 percent risk-based capital as well as all the regulators. And I find that, for example, a mortgage loan, even if it has a 20 percent or 90 percent loan-to-value ratio, is in the same bucket, which makes no sense, and banks are not given credit for the differences in loan to values, durations or collateral. As another example, for the last 10 years in McHenry Savings Bank, my commercial real estate loans have had zero losses in 10 years. My overall loss has been less than one-tenth of 1 percent on my whole portfolio because I am a heavily collateralized lender, and I am not getting any credit for my asset risk in that regard.

Mrs. BIGGERT. Thank you. I have just a short time left, so if anyone else would like to comment on this? No statements? Okay.

Yes, yes, Mr. Dewhirst?

Mr. DEWHIRST. In general, I would say that regulatory capital has no role or a de minimis role in pricing. The principles that are the basis for regulatory capital, the risk-based capital principles, do drive our pricing decisions, and that has been true for a long time. But we don't focus on the regulatory capital side of things in looking at those decisions.

As Basel II is implemented, what will happen is the methods of regulatory capital will become more in line with the pricing disciplines that we are using already.

Now, to the general question of mortgages, I would tend to agree with the comments that risk in mortgage assets is overstated in Basel I. I would just make the observation that Basel II is moving in the right direction in reducing those risks, so to the extent that it is a more rational assessment of the risk in those assets, that should help. The problems that were mentioned about excessive risk weights for mortgages are problems in Basel I that we would all hope to correct.

I don't really have a strong answer for whether regulatory capital plays a more important role in the management of a community bank. I know that we hold more capital at Bank of America than is required by the regulators by a long shot. So regulatory capital is not a constraining factor.

Mrs. BIGGERT. Thank you. Thank you very much. My time has expired. Yield back.

Chairman BACHUS. Thank you, Ms. Biggert.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman. I haven't had a chance to read the testimony, so I am upset at myself. I have a fundamental question, maybe I am missing something. Sometimes I find out when I ask fundamental questions I may not be the only one

who is missing something. And that is I am trying to understand how it is that a capital charge is supposed to alleviate, diminish, compensate for operational risk. I understand a capital charge with regard to lending, and I know you are not, on the whole, all advocates of it, but I want to understand—I mean is it—there are a couple of possibilities.

One is that a capital charge somehow will give you an incentive to avoid the dangers, I don't think anybody is really arguing that. Is it that the amount of capital you have to put aside, is that supposed to be able to take care of any losses in operational risk so that we don't have to go to the fund? What is the relationship? From their standpoint, as you understand it, how will requiring you to put up this amount of capital help us avoid the problems that would result from the operational risks becoming real problems? Yes?

Mr. GILBERT. Thank you, Congressman. One can never say that will help you avoid all problems. No capital charge could do that at a reasonable cost. I think the best way to think about an operational risk capital charge is in the context of an entire risk management framework. It is not an end in and of itself.

Mr. FRANK. What contribution does it make to this? I mean I can't look at the whole thing. I need to know what is better because we have a capital charge for operational risk than if we didn't?

Mr. GILBERT. Right. Because it makes the risk that we run in our operations much more transparent, so the measurement processes, the control processes that feed into the capital make it much more transparent.

Mr. FRANK. You don't have to have a capital charge to make the risks transparent? Transparent to whom, I guess would be the first question.

Mr. GILBERT. Well, it certainly makes it more transparent to our internal businesses and risk managers. It provides them incentives to control those risks——

Mr. FRANK. How does it provide them an incentive to control the risks that they don't otherwise have? I mean would a capital charge go down if they——

Mr. GILBERT. Yes. In a risk-sensitive regime, if they have stronger controlled mechanisms that are experienced——

Mr. FRANK. And you mean the people running the operation don't have an incentive to reduce those anyway? I am really skeptical that a capital charge in terms of transparency internally. I mean, first of all, doing a lot of capital charges through management supervision would seem to do this, but your argument is that the capital charge increases the internal incentive to avoid the dangers and also makes people more aware of what they are? It would seem to me there are better ways to do that, and I would hope that they would be doing that without this.

Mr. GILBERT. They largely do, but the capital charge internally puts a highlight, a stamp on that, if you will, and helps make transparent what it costs to the organization of not——

Mr. FRANK. Let me ask others what they think about either that particular justification or some others?

Yes, sir?

Mr. ELLIOTT. At Mellon, we take an entirely different viewpoint here. Where we have tried to focus our resources——

Mr. FRANK. No, no. I am asking you—Okay, well, go ahead finish this if it is directly responsive.

Mr. ELLIOTT. I think it will be, sir.

Mr. FRANK. Okay.

Mr. ELLIOTT. Where we have tried to focus our resources around the operational risk side of things is not on a capital charge, which really is in many ways a black box, especially to people on the inside. But it is really to focus in terms of the basic fundamentals of risk management, starting all the way at our board of directors——

Mr. FRANK. I understand, sir. Let me ask you this: Would a capital charge give you any greater incentive, do you believe, to deal with risk?

Mr. ELLIOTT. Not in our view, no.

Mr. FRANK. Yes. I mean I would think you would have—I mean what are the operational risks? Are you talking about theft, about fire, about——

Mr. ELLIOTT. The more relevant ones, typically, on the part of financial services that we deal with, which is more the processing and asset management businesses, are errors in pricing, there are errors like in not doing a corporate action, recognizing a merger or an acquisition type of transaction, and they are typically very modest in proportion if you——

Mr. FRANK. Okay. But, again, I don't see—it does seem to me you have every incentive to avoid those anyway, so I don't see what a capital charge—what about transparency? Would a capital charge increase transparency in your operation?

Mr. ELLIOTT. No, sir, not the way we look at it. We would see it in terms of basically having those strong internal risk management systems is where your first line of defense——

Mr. FRANK. Let me ask if any of the others have any—yes, Mr. Dewhirst?

Mr. DEWHIRST. You asked if there is an incentive created by a capital charge. I think that the question or your skepticism would apply equally if you asked the same question but changed operating risk to credit risk or market risk. There are incentives for good managers to manage credit risk. There are incentives for good managers to manage market risk. The thing is that people aren't perfect, markets aren't perfect, events happen, things go bump in the night.

Mr. FRANK. How does having a capital charge help then?

Mr. DEWHIRST. Capital is there to protect the bank and the bank shareholders and the——

Mr. FRANK. Okay, but it is not an incentive. It is——

Mr. DEWHIRST. The capital is there to protect against economic loss.

Mr. FRANK. Right.

Mr. DEWHIRST. If the system is one that gives you a lower capital charge to the extent that you are better able to control your risk, whether it is credit or operating or whatever, then you have an incentive to control that.

Mr. FRANK. You think the analogy between credit risk and operational risk follows very closely?

Mr. DEWHIRST. Sure. In the examples mentioned earlier, many of the operating risks mentioned were kind of minor and routine, like fraud. And my opinion is they are not so much for those routine losses as for the bigger ones.

Mr. FRANK. Like what?

Mr. DEWHIRST. Market timing, like late trading. If a company doesn't have the right kind of controls in place over its operations to make sure that people don't do those things, they can lose a lot of money, and capital is there to make sure that that——

Mr. FRANK. Okay. Let me ask you this, though—and I would appreciate a little extra time if I could—of course what you are saying is if you have those controls in place, you will then get a reduction in the capital charge?

Mr. DEWHIRST. I would hope that eventually that is where the system goes.

Mr. FRANK. Oh, that is very attenuated. It is not currently—you wouldn't get any today? Because it can't be an incentive if you don't get it. Is that not built in today?

Mr. DEWHIRST. Certainly, on the capital side, the direction we would move——

Mr. FRANK. No, I am not talking about on the operational risk side. You are saying——

Mr. DEWHIRST. There has been an evolution in the regulation that starts with formulas like 20 percent risk weights for securities and has evolved towards an actual assessment of losses on credit risk. On the operating risk side, to the extent that you have an advanced approach, what I would expect to see happen is that your own data and models that project how much you could lose would tend to support a particular capital level, and as the regulators get more confidence in your loss history and your projections of future losses, your own history of good risk management ought to lead you to lower capital——

Chairman BACHUS. Mr. Frank——

Mr. FRANK. I have one last question, which is I thought we were talking about unexpected losses, and how does that fit into——

Chairman BACHUS. Let me do this: Let me recognize Mr. Murphy and then I will come back.

Mr. FRANK. All right. I apologize.

Chairman BACHUS. Mr. Murphy?

Mr. MURPHY. Thank you, Mr. Chairman. I only have a time for a quick question here, although there is nothing quick when we are talking about the Basel Accord.

But a question for Mr. Elliott. I know the Fed has done a preliminary study on the effect of Basel II on mergers and acquisition activity within the whole banking industry. It concluded that any potential drop in capital accompanying the accord would have little impact on merger activity. However, they did admit that because of relevant data, and I quote here, "The results are statistically insignificant, and in cases where results are statistically significant, quantitative magnitudes are small." What is your opinion of the study and statements like that?

Mr. ELLIOTT. My perspective on that is that it is like any study, it is a little bit backward looking, it is not forward looking. And when you look in terms of the potential consolidation of the financial services industry, obviously the winners are going to be the ones that have the large capital resources to basically provide acquisition opportunities. And if you don't have strong capital, you are not going to participate in the consolidation of the financial services industry.

So my view would be it is an interesting study but more backward looking, and any evaluation has to be more forward looking in nature.

Mr. MURPHY. Are there elements here in the accord which would help or hinder—and I guess I will open this up to all the panelists—help or hinder the flexibility of allowing institutions to move forward in best ways with regard to mergers and acquisitions. I mean the idea being that we don't want it to just be a couple of big players end up acquiring everything but allow the marketplace to work here. Are there elements that you think help or hinder overall?

Mr. ELLIOTT. Potentially it helps the larger financial organizations to the extent they free up capital from some of the other aspects of the Basel II Accord. You do have to take into consideration, however, that basically the marketplace is going to be the real determinant around the amount of capital you need in a consolidating type environment. Others may have a different view.

Mr. MURPHY. Any other panelists have a comment on that?

Ms. MARINANGEL. I do. I think that when the larger banks that would be able to adopt Basel II would be able to deploy their capital, I believe that they would be able to buy a competing smaller institution and then convert those assets into a more efficient use by having less capital required. And so I think that that will encourage mergers and acquisitions to occur, because they will be able to deploy the capital of the acquired bank.

Mr. MURPHY. Is that a positive or negative?

Ms. MARINANGEL. Well, I think that perhaps for those community banks that want to be sold, it is a positive. But I think it is a negative long term because I believe that community banks serve functions in the communities that the large banks sometimes can't address. So I think it would be a negative. There are a lot of de novos that are opening to service the needs of communities as community banks.

Mr. MURPHY. Thank you.

Mr. Gilbert, you had a comment?

Mr. GILBERT. Just to take a different view, I just believe that regulatory capital will have no role in bank decisions about whether to merge or acquire another bank. As Mr. Dewhirst said, we make our decisions on all sorts of factors, largely driven by our economic signals, economics of the marketplace. Regulatory capital is not on the radar screen as a drive of decision making in that regard.

Mr. MURPHY. So we have some differences of opinion here? Well, that helps clarify this point.

[Laughter.]

Mr. MURPHY. Thank you, Mr. Chairman. I remain obfuscated by the——

Mr. DEWHIRST. I guess I would say or ask you in any article you have ever read about a bank merger, did anybody ever talk about regulatory capital as a driver? It is never on the table.

Ms. MARINANGEL. It could be, though, in the future because of Basel II.

Mr. MURPHY. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Murphy.

Ms. Maloney?

Mrs. MALONEY. First of all, I would like to welcome one of my constituents, Michael Alix, and thank you for your testimony today.

I would like to ask you about your—you mentioned in your testimony the trading book. Can you elaborate on this issue and discuss how it may impact your firm and similar firms under Basel II?

Mr. ALIX. I would be delighted to, thank you. The trading book is a concept in the Basel Accord which allows positions and businesses to have their regulatory capital calculated using a market risk model. And the idea behind the trading book is that assets that are in the trading book are marked to market, held for sale and actively managed as market risks. That describes virtually all of the activities of the major investment banks. There are some exceptions, but virtually all of the inventory positions and activities in the investment banks would be encompassed in a trading book.

However, it also includes activities which in commercial banks are in a banking book, and a banking book is more of a held-to-maturity traditional lending concept. And what we fear from our discussions with regulators, both in the U.S. and around the world, is that the activities that we have effectively managed for years and years as market risks could be recharacterized as banking risks.

That includes, for instance, mortgages purchased with the intent to securitize, loans purchased with the intent to sell. Those activities are recharacterized as banking book activities. It has two harmful effects. Number one is it causes us to have to build infrastructure to collect data and make calculations on those activities that we wouldn't otherwise do for our own purposes. We would not think it would be relevant information.

And the other thing it does is to create a disparity in the actual capital charge between the banking book and the trading book such that investment banks, which have already recognized the expected loss in the activity through the mark-to-market process, would then be asked to take a capital charge on top of that. The reserves, which banks would hold against those activities, and which are, in some measure, expected losses, would continue to be allowed as capital under the Basel Accord. So that disparity would cause us a concern.

Mrs. MALONEY. Thank you. Getting back to the point that Mr. Frank was making, and I would like to ask all the panelists to comment if they would, why would it not be more advantageous to all United States financial sector institutions to move operational risk to Pillar 2 and disclosure under Pillar 3? And wouldn't that solve the competitive problems better and protect better against

risk, with the regulators and supervisors looking at it. Would anybody like to comment on that?

Mr. ELLIOTT. Well, that is precisely our proposal, and we think one of the things that you have outlined is basically getting to the heart of the matter. Each individual organization is different here, and it is very difficult to take something that is really unproven, basically mathematical formulas, and try to level set it as it relates to a capital charge. We think the aspect of regulators understanding an organization and its activities well goes a long way to answering the operational risk aspect. Disclosures, we think, just continue to add to the transparency that has been discussed. So we would be very much of a like mind with yourself.

Mrs. MALONEY. I would like all the panelists to answer if they would. What would your position be on moving operational risk to Pillar 2 and disclosure under Pillar 3?

Mr. GILBERT. Thank you. As I mentioned in my testimony, I think if you had a Pillar 2 approach to operational risk, you can imagine your supervisor coming to you and saying, "Okay, we are here to discuss how you handle operational risk and whether you adequately address it in your risk measurement and capital systems. So please now show us the data that you have collected that helps us understand how you have adequately addressed this particular issue."

That is the same exercise, essentially, that you would go through to have a Pillar 1 capital charge. In fact, if you did that across the board, subject to standards that are broadly agreed in the industry as part of Pillar 1, you would have a much more consistent framework than a bilateral discussion that would not only go on here but across the world for banks that we actively compete with across a wide range of businesses. So we just think it improves the transparency to make that a Pillar 1 charge.

In terms of the point about unproven, I think we and other banks have been doing operational risk internal capital for some time. We think it is working quite effectively, and so we would challenge the idea that it is unproven.

Mrs. MALONEY. Sir?

Mr. DEWHIRST. My comments are very similar. First, on the consistency and transparency point, I think it is evident that you would have more consistency and better transparency with models that are publicly discussed and used——

Mrs. MALONEY. But why would it be more transparency? Why would it be more transparent?

Mr. DEWHIRST. Imagine the situation, as Mr. Gilbert suggested, where each regulator at each bank has a somewhat idiosyncratic approach to assessing the risks at that bank. The constituents who care about risk management at that bank, shareholders for example, would not know exactly what idiosyncratic standard those regulators were——

Mrs. MALONEY. But if you had it under Pillar 2 and Pillar 3, which Pillar 3 is just disclosure, wouldn't it be totally disclosed? If it is under Pillar 3, it would be totally disclosed. Why wouldn't it be transparent if it is required to be disclosed?

Mr. DEWHIRST. Disclosure is an area where it is difficult to achieve a standard which is high enough that everybody learns

what they—in other words, you have disclosures in a lot of other areas that still create confusion, and I think that——

Mrs. MALONEY. What if we had a standard for disclosure?

Mr. DEWHIRST. If you have a standard for disclosure that really explains how risk is being done in a consistent way across the system, you would have to have a methodology that was consistent as well.

Let me just add one other comment on the maturity of the process. The comment that operating risk management is so new that we can't do it I think is contradicted by the fact that the insurance industry has been looking at these kinds of risks and analyzing them in a very statistical way and projecting losses for many, many decades. And what we are really talking about is just an extension of many of those same techniques.

Mrs. MALONEY. I would feel that it would be better to move the operational risk to Pillar 2, the abstract nature of operational risk. I believe a capital charge would not have any significance towards operational risk, and I would not want to see a capital charge for operational risk. I would rather have it be disclosed or have regulators discuss it as they do currently.

Ms. JANSKY. I believe that we need to consider the fact that it would take some time to develop for a lot of institutions, perhaps not all of those that are at the table today, but for a number of us to go back and develop all of the information that is necessary and to develop that over long periods of time to really build the models that support operational risk at our institutional level. Our big concern is it is going to take quite a bit of time, so we would support moving to Pillar 2.

Mr. ALIX. I think our firm and the firms I am speaking on behalf of in theory agree with the idea of a Pillar 1 requirement and in theory agree that there ought to be capital set aside for failures of people, processes and systems. Those failures are inevitably going to happen, and there ought to be, as we do a better job in the Basel II Accord, a much better process of measuring and isolating the unique market and credits risks, which for the most part create a reduction in capital requirements. To have an isolation of capital for operational risks would be, in theory, a good thing.

In practice, it is very difficult, and while some institutions have made some significant progress, we, in looking at some of the methodologies that are out there, are somewhat skeptical of their applicability to our firms. And so we would like to ensure that if we continue along the path of having a Pillar 1 capital charge for operational risk, that it be sensitive to the unique operational risks that our firms wear and not try to apply a one-size-fits-all approach.

Mrs. MALONEY. My time has expired—unless you had a point to make.

Mr. GILBERT. I just wanted to make one additional comment if I could. Basel II is a package that includes judgments to credit and operational risk charge. If we were to remove the operational risk component from Pillar 1 without knowing in great detail, my sense is that the supervisors would feel compelled to recalibrate the rest of the remaining Pillar 1 and capital framework, and that is market risk and credit risk in particular.

And I think that the law of unintended consequences would take over, because you would force them to kind of recalibrate in a way that would move the credit risk charge in particular away from the underlying dimensions of risk, and that would be unfortunate, because what we are trying to do in Basel II, in the first instance, is link those risks more closely.

Mrs. MALONEY. Could I do a brief follow-up question on this just to try to clarify it from the statement and Mr. Gilbert and Mr. Dewhirst? Basically, are you saying that because we have several financial regulators, that we would not be able to achieve consistency or transparency through supervision? Is that your point? Could you clarify a little more?

Mr. Gilbert and Mr. Dewhirst, from your comments.

Mr. GILBERT. It is not just that we have several regulators in the United States. We have regulators all across the world, and so absent some very clear standards which are the core of Pillar 1, because Pillar 1 isn't just a formula in which you calculate a capital requirement but rather it comes with operational standards that the supervisors expect the banks to adhere to.

Without the consistency that is associated with those standards as well as the calculation itself, what you end up having through Pillar 2 is really a whole series of bilateral discussions across—in our case, across 50 countries that becomes unworkable and in inevitably will be inconsistent and not transparent. And, therefore, we would be concerned about something like that in the Pillar 2 framework, and the Pillar 1 framework makes that much more explicit.

Mrs. MALONEY. Thank you.

Mr. DEWHIRST. And I would just add that even if you imagine a world where there were one regulator, you have different examiners in charge of exams at various institutions, and there is variability among the set of standards that they apply, which is inevitable because they are people.

To the extent that you have a uniform approach that they are attempting to adhere to, you minimize that, and specifically you see a regulator issue a set of guidelines for how they examine a particular risk. If you don't have uniformity, then you risk a lack of consistency.

Mrs. MALONEY. Thank you for that clarification, and thank you for the time, Mr. Chairman.

Chairman BACHUS. Thank you.

Ms. Jansky, in your testimony, you mentioned the arbitrary minimum capital standards that have been set for commercial real estate lending.

Ms. JANSKY. Yes, sir.

Chairman BACHUS. Why do you think that our U.S. regulators agreed to these arbitrary capital lending minimums?

Ms. JANSKY. I could only guess about that, sir, but I would say that I think that a great deal of work apparently had been done, and they were looking back in time and looking at asset correlations and asset performance over the last two or three cycles. My concern with that is there are a lot of other factors that have to be taken into consideration. There were lots of reasons for the different cycles that we went through.

There has been lots of change since those, particularly the last commercial real estate cycle, as it relates to both the introduction of FDICA but also it relates to the elimination of the tax incentives that existed back in the 1988 era when we had so much oversupply of product that was built, not because of demand in the marketplace but frankly because of tax incentives.

We have asked a lot of questions. We have asked for empirical evidence, we have asked to see support, and we frankly have just yet to see anything that we find that leads us to that same conclusion.

Chairman BACHUS. Do you think they could be more concerned about maybe risk management in Europe as opposed to here?

Ms. JANSKY. I can't answer that question, sir, I don't know.

Chairman BACHUS. Okay. But you have pretty clearly testified that you believe it will have a negative effect on commercial real estate lending in the United States?

Ms. JANSKY. I believe it can have a negative impact in certain products as we begin to rationalize and begin to work towards an efficient utilization of capital, those products that require higher capital, if you cannot get the right price in the market or the price tends to be higher than perhaps non-financial institutions providing that product, I do think we will see it become an issue for certain markets. Yes, sir, I do.

Chairman BACHUS. And if the capital charges for certain acquisitions and development and construction loans remain as drafted, will SouthTrust—or SunTrust——

Ms. JANSKY. I don't think SouthTrust is worried about it.

Chairman BACHUS. New Wachovia, right?

[Laughter.]

Will SunTrust and other institutions, you think, be—I will just say SunTrust—be forced to make fewer loans?

Ms. JANSKY. I wouldn't say today, because I really think it is too early to say that, that we would be forced to make fewer loans, but I would say that that line of business, as all of our lines of business, as we assess the capital required to run our total operation as we get more efficient there, we will look at the capital allocation for that line of business, and it may force them to reconsider what their targets are in the market.

Chairman BACHUS. Okay. I will ask this question of all witnesses. There have been significant innovations in commercial real estate risk assessment that have been employed in the last 10 years, and I think, Ms. Jansky, you mentioned that. Do you believe that acquisition development and construction lending has gotten more or less risky over the past 10 years?

First of all, I will ask—just start with you, Mr. Elliott. Do you think it is more risky or less risky?

Mr. ELLIOTT. The perspective that we have is that we, in essence, are not in that line of business, so mine would be a little bit more as an outside observer. I think an outside observer's perspective would be that I think people understand the risks a lot more, they have monitored the risks a lot better than what they would have historically, and people have built their loan portfolios in a much more diverse manner so that to the extent they do have any issues

inside the portfolio, they are able to handle them from a financial perspective.

Chairman BACHUS. Does Mellon do residential lending?

Mr. ELLIOTT. Very selectively for high networth individuals, yes.

Chairman BACHUS. Okay. Do you think that that has become less or more risky?

Mr. ELLIOTT. I think it has become less risky because the way that we do it. We have very low loan-to-value type ratios associated with it, and we typically have other collateral associated with those loans in addition to the property.

Chairman BACHUS. But you all just aren't in that market that much.

Mr. ELLIOTT. We are not a significant player, no.

Chairman BACHUS. How about, Mr. Gilbert, JPMorgan Chase and I guess Bank One now?

Mr. GILBERT. Yes. Thank you. My new partners at Bank One I think are more engaged in the real estate lending business than we have been at JPMorgan Chase, but I think I would agree with Mr. Elliott on the comments about the relative riskiness. But, of course, the thing to keep in mind is that relative risk in this type of activity is also a function of the State of the economy, and we have generally had a benign economic environment, certainly for in the nineties. We had some problems early, of course, in this decade, but you can see that it is a lot—that the economic environment on the whole is a lot better than, say, the previous decade.

And I think if you take a long historical view, I think, as the Fed has published in its study on real estate, you find that this is not a riskless activity by any means, but you can make relative risk statements about various points in time, but I think what is most prudent to do is take the longest possible historical view.

Chairman BACHUS. Okay.

Mr. Dewhirst?

Mr. DEWHIRST. My answer is colored mainly by my experience in New England and history at Fleet there. New England went through a very traumatic period in the real estate market in the nineties. I think that taught people some lessons about mismanagement and underwriting, and so I would say that market has become much less risky over time. And I would also echo Mr. Gilbert's comments that the business cycle seems to be becoming less volatile, and that helps credit risk in general, including both commercial and residential real estate.

Chairman BACHUS. Ms. Marinangel?

Ms. MARINANGEL. I agree that the acquisition development and construction lending have become less risky. Being in the Midwest, that is generally a stronger economy, and because of the interest rate cycles as well, I believe that it has become less risky. Hopefully, it will stay that way, but when you have good business environment, generally it is less risky.

Chairman BACHUS. All right.

And Ms. Jansky, you have already testified that it has become less risky, I believe, both residential and commercial, in your opinion?

Ms. JANSKY. Yes, sir. I would just comment that I believe that we have had a lot that is happened over the last 10 years and the

advancement of risk management practices in our industry. I also believe there is a great deal more transparency in the commercial real estate market. I also believe that real estate developers have had a much more consistent approach to market and have been somewhat more conservative than I observed over the last 25 years in the business.

Having said that, I am not sitting here today and saying that there won't ever be additional real estate problems because there will, but I believe that the industry has done a very, very good job, and I believe a lot of regulation in certain areas, but at the time we would have been careful but now it looks to me like we are very prudent and it has helped us to make sure that we are managing that risk. And I think the industry as a whole is managing it much better.

We also have to remember that we have had some very high vacancy factors across the country in different markets. We have had lots and lots of new starts that have been pulled from the market, but we have been in an incredibly low interest rate environment. So you have to balance all of that as you look at the relative risk. But we feel very comfortable with it, and we just want to see a lot more documentation and more of a forward thinking about the risks associated with commercial real estate.

Chairman BACHUS. Mr. Alix, Bear Stearns is not really in that market.

Mr. ALIX. I would suggest that we are but in a very different way than the other panelists. One of the things that hasn't been mentioned I think as a positive in commercial real estate lending has been the enormous development of a robust capital market for securitized commercial real estate loans.

And our firm, as well as others in the industry, have a very active business in originating and purchasing loans from other originators, packaging those loans in large and diverse packages—diverse by geography, diverse by property type, et cetera—and selling pieces of those securitizations to institutional investors.

That has diversified the ultimate holders of the risk and has ensured that if there were a problem, another problem in commercial real estate lending, the pain would be distributed a little bit differently than it was the last time around. So I think that is a very positive development.

I also believe that this is an area where our argument for trading book treatment is crucial, because these are loans that if we applied banking book, which the other witnesses argue is extremely conservative, if we apply banking book capital charges to our commercial real estate loans held for securitization, it would have a very detrimental effect on the regulatory capital charge.

Chairman BACHUS. All right. Thank you. You know, I will say we are going to hold a hearing tomorrow on non-prime lending, and I am sure we will touch on securitization in that lending is somewhat threatened by some liability questions, as you know.

I will say this—I am going to yield to Mr. Frank for as much time as he may consume. Before I do that, I do want to say—I want to offer one cautionary note that I have as far as the residential real estate lending market, and that is we have been in a historic period, I would say, for the past several years of low interest

rates where people that weren't able to afford mortgages before because of low interest rates were—many of those residential mortgages are adjustable rate mortgages.

And I am not sure that if we have rising interest rates out of a very low interest rate, residential mortgages and adjustable rate mortgages as opposed to fixed rate mortgages, I am not sure what kind of stress that will put on the market. I am not sure that we—I am sure you all factored some of that in. Anybody want to comment on that? Is that a concern?

Mr. ALIX. I would suggest, as a firm that has a significant mortgage capital markets business, that prudent risk management would compel us to do sensitivity analysis and stress analysis for the sort of scenario that you are describing. And one observation would be that the market seems to have absorbed the increase in volatility and interest rates in the mortgage markets quite well, but time will tell as to whether the ultimate home value and delinquency rates are affected by a materially higher interest rate environment.

Chairman BACHUS. All right.

Mr. Dewhirst?

Mr. DEWHIRST. Well, certainly, it is a concern, and it is one that we have looked at for many years. When you get burned once in a particular area, you tend to focus on that for the rest of your life. The one caveat I would put around the growth in the ARMs market is that many of the most popular ARM loans have a fixed period that is quite long in the front. So I just bought a house myself in Charlotte, preparing to move down there, and it is not only an ARM but there is 10 years of fixed rate in front of it.

So I think there is a possibility that in just looking at aggregate ARM numbers, we can exaggerate the exposure. Many of the people that have 5-, 7-, 10-year ARMs will have moved or refinanced by the time that those fixed rate periods end.

Chairman BACHUS. That is a good point. I am not sure I was considering that.

Mr. Frank?

Mr. FRANK. I want to return to the question of incentive, et cetera, and I would say I agree with Mr. Dewhirst. I have advanced the argument that you can't do the operational risk capital charge because we don't know how to measure it, but it does seem to me that acknowledging that they have made significant progress in measuring it cuts the other way as well. That is, I understand the importance of some uniformity and standards and the problems of inconsistent application.

I don't understand what a capital charge adds to that. That is, why can't you do all those things you were talking about, promulgating uniform standards, et cetera, under a management approach? What does promulgating a number, a capital charge, add to that administrative procedure, because I agree with everything else you have talked about.

The second point I would have is this: You said that the incentive works this way, which is logically straightforward as you say it. Once there is a capital charge, you would get an incentive to improve your procedures because that way your capital charge could be lowered. But the people who would decide to lower the capital

charge are the people who are checking. I don't understand why you would still have the same group of people monitoring your procedures.

Now, without a capital charge, they are monitoring your procedures and passing on their adequacy. With a capital charge, they are monitoring your procedures and passing on their adequacy so they can reduce the capital charge. I literally don't understand how a capital charge adds to the transparency, the rationality. All those things could be done, it seems to me, by administrative regulation and requirement without a capital charge.

So, particularly, for Mr. Gilbert, I guess, and Mr. Dewhirst. I would be interested in your responses.

Mr. DEWHIRST. Let me make two—well, a comment and ask a question, sort of turn it around and maybe I can get clarity on what your concerns are.

Banks already hold capital. There is implicitly a capital charge for operating risk. If large losses occur because of operating risk losses, the shareholder pays.

Mr. FRANK. Mr. Dewhirst, I understand that, but that is not answering my question.

Mr. DEWHIRST. Well, then let me try to understand it by asking this.

Mr. FRANK. Go ahead.

Mr. DEWHIRST. We insist on a certain approach to credit risk. We say there ought to be a methodology for deciding how much risk there is in the assets we have, what the possibility is of unexpected losses occurring in those assets, and we ought to have capital that is scaled to that. What is different about operating risk?

Mr. FRANK. Well, I think there are some differences in terms of what you are dealing with. Loan losses are expected, but I do want to go back to your question. I have to say this: When you don't want to answer my question but want to ask me one in return, it suggests to me you haven't thought of the answer yet. I will take it in writing later.

But you were saying that a capital charge deals with the following problems. First of all, it deals with the problem of inconsistent regulators. Was I correct in hearing you that way, that you said that one of the problems that leads you to be for capital charge is the difference and inconsistency among regulators; is that correct?

Mr. DEWHIRST. A capital charge under the advanced approach. We could do that.

Mr. FRANK. Yes. Right. And that is a way to get around—to diminish the problem of inconsistent regulators. It would increase transparency. You would have one set of standards. My question to you is why can't you accomplish all of that by regulation and by promulgations without a capital charge and don't in fact even if you have a capital charge, you still need to get them together and do that.

I think that what you are saying is, well, only if there is a capital charge—the capital charge in and of itself doesn't do any of that. The capital charge does not homogenize or regularize or get uniform. You still have the individual basis. Why is the capital charge

necessary to achieve all those other things which I think we ought to achieve?

Mr. DEWHIRST. You may be able to achieve consistency and transparency without the capital charge.

Mr. FRANK. No, that is not my question. My question is what does the capital charge add to it?

Mr. DEWHIRST. I understand. What it adds is what capital adds for every other risk, which is a cushion against loss.

Mr. FRANK. Okay. Then that is a different question, I understand that. And that is what I was asking my question, but that is a different justification than the one you gave. That is fine.

Mr. DEWHIRST. It was——

Mr. FRANK. Excuse me, I am going to finish. I have to be honest with you, even if you weren't moving out of my district, I would still interrupt you. You are moving to Charlotte, so I don't mean to—I do that with people.

Mr. DEWHIRST. Not before the next election.

Mr. FRANK. Weak opposition this time. It is not a problem.

[Laughter.]

But here is the point. Here is the point: If you had said that originally, we wouldn't be having this discussion. I understand that argument that a capital charge is there to provide money to make up for the risk, but in addition to that, and I really think you have to deconstruct all these arguments, there is an argument that a capital charge incentivizes you, et cetera.

In other words, one argument for capital charge is that it diminishes the likelihood that there will be risk which the capital will be used to fill up, and the argument that you need a capital charge to deal with losses, I understand. I would have dealt with that earlier if we had gotten to it earlier. The argument that a capital charge improves the quality of regulations somehow increases transparency and deals with the problem of inconsistent regulation, I am unpersuaded.

Mr. DEWHIRST. Let me make a distinction. Again, it is based on my analogy to the credit risk capital framework. Under Basel I, all commercial loans were 100 percent risk weight. Not all commercial loans have the same amount of risk. The capital charge did not do anything for transparency or did not do much for transparency. It did a lot for consistency but not a lot for transparency. It certainly didn't tell the shareholder or the debt holder in a particular bank whether the loans were extremely risky or not.

The advanced approach goes to a very different standard where the capital assigned is going to be proportional to the risk assessed, based on estimates of probability of default, loss if default occurs, exposure and so on. Under that system, there would be an incentive—the capital charge would create an incentive for better risk management, because to the extent that you could reduce probability of default or loss given defaults, you would have a lower capital charge. Now, if we can——

Mr. FRANK. But you have a lower capital charge only if the regulator examined your procedures and felt that you had achieved increased efficiency and therefore you were entitled to a lower capital charge.

Mr. DEWHIRST. Yes.

Mr. FRANK. And my question to you is why can't we have the regulator do that without the capital charge? In other words, in each case—excuse me, I want to finish this—in each case, we are relying on the regulator's analysis of what you have done and the regulator having analyzed what you have done says, "Oh, you did a pretty good job." Well, why can't we give the regulator the power to enforce that? Why does he need the ability to reduce the capital charge to have the ability to do that?

Mr. DEWHIRST. If you again go to the credit example, with 100 percent risk weights for all commercial loans, the regulator comes in——

Mr. FRANK. Well, you are going back and forth with the credit example. The credit example is sometimes relevant and sometimes isn't. If you can't answer it in terms of the operational risk, then I am skeptical.

Mr. DEWHIRST. The analogy to operating risk would be exactly——

Mr. FRANK. Well, explain to me then why does the regulator need a capital charge to be able to look at those procedures, evaluate them and pass judgment on them?

Mr. DEWHIRST. They don't, but then what happens?

Mr. FRANK. Okay.

Mr. DEWHIRST. In order for there to be an incentive—I mean there could be banks that are extremely well capitalized, very well capitalized, marginally well capitalized that a regulator would come in and—I mean a regulator just wants to have a certain level of capital so they can ensure the safety and soundness.

Mr. FRANK. I didn't say that. That is the loss to me. That is a separate argument, and I would like to return to the one we are talking about. It is very important to sort them out.

Mr. DEWHIRST. I am sorry, say that again.

Mr. FRANK. That is the loss provision, to make up for losses, but that is a separate one from the—I mean I did notice you said it didn't add to transparency. I mean I am trying to understand what it is over and above capital to make up for losses that makes it important to have a capital charge. I don't understand how it adds to transparency, how it adds to the incentive, how it—I mean you still haven't gotten to me on that.

Mr. DEWHIRST. Under the current system, I would say transparency is minimal because—and I am going to the lending approach because what is happening now is the regulators are trying to make the operating risk approach more like the lending approach. But under the current lending approach, 100 percent risk weight for all commercial loans, it is very hard for anybody to know what is going on, because it is 100 percent for every kind of loan. You don't get detail.

If the system went to the advanced approach and capital were allocated by risk, then you would know both from the process and probably from the disclosures that banks that had more capital for credit risk had more risk.

Now, if you did the same thing under the operating risk framework, you could have two different approaches. One approach would just be all banks or all financial institutions have a certain

level of risk. One of the early Pillar 2 approaches said operating risks in proportion to revenue.

Mr. FRANK. That is a strawman, nobody said that. But it is a strawman, it doesn't help us to throw it in here.

Mr. DEWHIRST. But it is very similar to——

Mr. FRANK. No, it isn't. What we are talking about is—we have agreed that there needs to be—and I am going to end this now because we are not getting anywhere—we need—yes, we want to have a system whereby the regulators look at things individually and at the same time you want both individuality and uniformity. You want regulators looking institution by institution, but you want regulators with each institution to have a somewhat similar approach. I agree with that. I just don't understand how at the end—beginning or ending with a capital charge in any way makes that likelier or easier to accomplish.

That is all, Mr. Chairman. We are going to end where we began.

Chairman BACHUS. Thank you. I am going to go ahead now and ask a question, and then Ms. Maloney will wrap up, but at least you have some——

Mr. FRANK. I am going to lunch, Mr. Chairman. I am going to go have lunch.

Chairman BACHUS. We are all going to lunch pretty quick here, including some students over here.

I have one question. It is actually for Mr. Alix, it is something you raised in your testimony. This spring we heard testimony from the U.S. and European government officials regarding the consolidated supervision issue. You talked about your concerns there. Last week, the International Subcommittee heard testimony from the U.S. financial sector regarding this issue as well. The securities industry in particular has now asked the committee I think for two weeks in a row to keep a close eye on the implementation of the commission's consolidated supervision directive.

So my question is this: What should members of this committee do in monitoring this situation?

Mr. ALIX. Well, first, I would say, as I said in the testimony, that we believe it should be unambiguous. There is no doubt that the SEC's form of supervision, which is embodied in the consolidated supervised entities rule, is first rate, world class, equivalent to the best supervisory programs around the world for financial institutions. And I think that the best thing that the people in this room and elsewhere in this city can do is to push the European representatives to abide by their deadlines in making that determination.

And if that determination is made, for instance, in the next few weeks, I think that will enable U.S. investment banks to get on with the business of making their applications and getting the exams done and putting themselves in a position without undue cost or burden to meet the requirements that the SEC has put forward. If there is a delay, that could be very damaging, both from the perspective of having to do more in less time as well as from the perspective of having the commission distracted by that particular issue still being open.

So we want it to be unequivocal, clear and final as soon as possible, and anything you can do to make that concern known to the appropriate people would be appreciated.

Chairman BACHUS. What if the European Commission and I guess the parliament can't conclude or finalize their work and make the necessary determinations in a timely manner? What could the Financial Services Committee do about this internally?

Mr. ALIX. Well, first of all, I don't think the equivalence judgment is a matter for the European parliament. I think that has been delegated to each firm's respective regulator of their principal activities in Europe. And so that is a matter for the regulatory agencies in Europe. To be honest, I think it is not something that we contemplate.

As I said, it is so obvious to us that it is something that we believe ought to be done right away. Were that not to happen, I think that would be sufficiently serious that it would inspire very high level across-Atlantic conversations about the implications, and I think that for our firms the prospect of having our operations ring fenced in Europe and not being able to enjoy the benefit of global franchises would make it very difficult to compete in some of our core businesses in Europe. And I think that would be very detrimental.

So, as I said, I would like not to contemplate a significantly longer delay or a decline of equivalence status, but if that were to happen, we would be very, very concerned.

Chairman BACHUS. I would ask all of you if your firms or your corporations have researched whether the regulators in the various countries have the legal authority to share supervisory information or oversight responsibilities, possibly join together in enforcement actions across borders?

Mr. GILBERT. I am not sure we have researched it as such. I think in those matters we tend to rely on the supervisors to discuss among themselves their ability to share information and pursue actions. We, of course, need to abide by the local rules that apply to the sharing of information, even within our own firm, so there are a lot of rules and requirements out there that can vary from country to country. But in terms of the ability of the supervisor to share information——

Chairman BACHUS. And really legal authority.

Mr. GILBERT. Right. We tend to have not looked per se at that issue but, again, rely on the bank supervisors themselves to determine that.

Mr. ALIX. If I might add, I would agree that it is a question better placed with the regulatory authorities here who have done the legal research, but it is my understanding that the SEC in the case of the investment banks has negotiated agreements with the relevant regulatory authorities about the protection of private information that they exchange in the course of their supervisory activities.

I think it is kind of interesting because we actually support cooperation among regulators to avoid, for instance, being asked the same question or being asked for the same information by 10 different regulators around the world. We would encourage them,

where appropriate, to consult with each other and share information where it is directly relevant to carrying out their activities.

Chairman BACHUS. All right. This concludes our hearing, and members will have five legislative days to submit opening statements. And the chair notes that some members may have additional questions for the panel, which they may wish to submit in writing. Without objection, the hearing record will be held open for 30 days for members to submit written questions of those witnesses and to place their responses in the record.

With that, this hearing is adjourned.

[Whereupon, at 12:15 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 22, 2004

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit
"The New Basel Accord: Private Sector Perspectives"
June 22, 2004

I want to thank the Gentleman from Alabama for all of his work in bringing the Basel II into the spotlight and making improvements to the Accord. Without his efforts, and the efforts of other leaders on this Committee, many of the important changes to the Basel Accord would not have been made.

This Committee has held three hearings on Basel II, approved legislation in this Subcommittee, written a comment letter on the proposed ANPR, and held numerous meetings with the regulators and the affected parties. The result of all of this hard work has been significant changes to the Basel Accord, increased cooperation among the federal regulators, and more sophisticated risk management.

The original Basel Accord establishes the amount of capital banks should hold against certain risks. It is an important agreement between the financial regulators around the world and has needed revision and improvement for several years. The business of global banking has changed significantly since the first Basel Accord was adopted, and Basel II goes a long way to bring risk management up to date.

When the Committee began its review of the Basel II proposal last year, the federal financial regulators were not in agreement on how the proposal should be negotiated, and were not communicating well with one another. The U.S. did not have a unified negotiating position, with some on the U.S. team ignoring the concerns of others. There is little doubt that this undermined the U.S. negotiating position. At the urging of the Financial Services Committee, the federal financial regulators began to communicate with one another better, they stopped bickering in the press, and the U.S. negotiating position improved.

I was extremely concerned that the financial regulators were moving too quickly to adopt Basel II. There was not enough information on the potential effect this sweeping agreement could have on both domestic and international banking. Since we first began examining the agreement the Federal Reserve has issued white papers on competitiveness and the effect Basel II will have on real estate lending, they have begun a bench marking study of operational risk, they have agreed to do another qualitative impact study, and most importantly, they have agreed to delay implementation of Basel II until the end of 2007. This delay will allow both the regulators and the affected institutions time to develop the necessary systems to run Basel II.

Last week the regulators announced that they would consider revisions to Basel I in order to limit any anti-competitive effects that the two-tiered capital system may have. The impact that Basel II could have on consolidation in the banking sector has been a concern of this Committee since we first began this debate. I welcome this announcement and will look forward to seeing more details of the Basel I reform efforts.

Important improvements to the treatment of expected losses and unexpected losses, credit card portfolios, and increased examination of the home/host regulatory issues have all been positive, however there are still a few issues that remain to be resolved. Commercial real estate, operational risk, and an assessment of the cost and complexity of the agreement still must be resolved.

I would like to thank the witnesses for coming this morning and I look forward to hearing your perspectives on the Basel II Accord.

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June 22, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit Hearing entitled, "The New Basel Accord: Private Sector Perspectives"

Thank you, Mr. Chairman, for holding this important hearing. I appreciate this opportunity to be updated on negotiations regarding the new Basel Capital Accord (Basel II) to regulate international banking risk.

Currently, over 100 nations utilize the original Basel Accord (Basel I) model for capital standards. However, I understand many financial institutions concerns that this general approach failed to take into consideration the specific characteristics of larger entities, frequently changing market conditions, and risk reduction strategies implemented by individual financial institutions.

I was happy to support this committee's action in passing HR 2043, the United States Financial Policy Committee for Fair Capital Standards Act, to require the development of a unified position for U.S. banking regulators before negotiating in the Basel Committee on Basel II and have been pleased to see our regulators come together on this issue. I was also happy to see federal regulators decide to delay U.S. implementation of the Accord until the end of 2007 to allow banks and regulators to better assess the potential impact of this new framework on our American banking market.

However, I do not feel that our federal regulators have adequately addressed the concerns regarding Pillar I treatment of operational risk expressed in a November 3, 2003 letter to Federal Reserve Chairman Alan Greenspan, Federal Deposit Insurance Corporation Chairman Donald Powell, Comptroller of the Currency John D. Hawke, Jr. and Office of Thrift Supervision Director James E. Gilleran signed by our House Financial Services Committee Full Committee Chairman and Ranking Member and all our Subcommittee Chairmen and Ranking Members.

In the US, the Basel II Accord and its operational risk-based capital requirements will cover only banks and not their non-bank competitors. This disparity will place banks at a substantial competitive disadvantage, particularly banks that specialize in the asset management, custody, and payments processing lines of business. These new competitive pressures could force some US banks to move these businesses out of the bank, sell them, or to de-bank completely. Such a development could increase systemic risk because major institutions would operate outside bank supervision.

It is also the case that the banking industry and federal regulators have yet to agree on a definition of operational risk. Many in the United States feel that the Basel Committee's proposal on operational risk gives only limited recognition to proven forms of operational risk mitigation and creates a perverse incentive to downplay insurance, contingency planning and similar activities that have proven effective.

I would like to see these industry concerns discussed this morning and look forward to hearing from our federal regulators on the possibility of Pillar II treatment of operational risk.

Thank you again, Mr. Chairman, for bringing these important negotiations to this subcommittee's attention. I look forward to a very informative session.

TESTIMONY OF
MICHAEL J. ALIX
SENIOR MANAGING DIRECTOR
BEAR STEARNS & CO, INC.

THE NEW BASEL ACCORD:
PRIVATE SECTOR PERSPECTIVES

BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
JUNE 22, 2004

Mr. Chairman and members of the Subcommittee:

I am Michael J. Alix, a Senior Managing Director of Bear Stearns & Co, Inc., and Global Head of Credit Risk Management, and also the Chairman of the Securities Industry Association's[1] Risk Management Committee. I am speaking today on behalf of my firm and a group of those members of SIA that are most likely to be applicants under the Securities and Exchange Commission's new regulatory regime for Consolidated Supervised Entities ("CSE").

I applaud the Subcommittee for holding this hearing on the Bank for International Settlements' Basel Committee on Banking Supervision's (the "Basel Committee") efforts to develop a new Capital Accord ("Basel II") and for giving me the opportunity to testify on this

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

key issue. The new Capital Accord is crucial not only to U.S. financial market participants but also to financial firms throughout the world. The Subcommittee's oversight of Basel II and its implementation has been very helpful to the financial services industry, including those investment banks that likely will be applying for global risk-based supervision under CSE.

My testimony today comes from the somewhat unique perspective of an investment bank viewing Basel II through the prism of the CSE framework. I wish to make the following points:

- It is essential that there be a European Union ("EU") "equivalence" determination on the CSE framework *vis-a-vis* the EU's Financial Conglomerate Directive ("FCD") in the very near future;

- Regulators must coordinate and cooperate with their regulatory counterparts around the globe regarding the implementation of Basel II /CSE if the goal of Basel II is to be realized;

- In order to ensure competitive equality among financial institutions, both banking and securities regulators must address certain remaining issues with Basel II. The recent formation of the Basel/IOSCO Working Group on trading book issues is a very positive step in this direction;

- Given that the FGD will become effective well before Basel II, there must be flexibility with respect to timing and implementation of standards as firms migrate to Basel II/CSE;[2]

- The CSE framework presents challenges not only to the private sector but also to the SEC. For some time the SEC's Market Regulation Division has been successfully transforming itself into a 'prudential supervisor' comparable to any other regulator of the global capital markets. We want to encourage the continuation of that process, and ensure that the Division has the necessary resources to achieve and maintain that goal; and

- Certain technical amendments of a number of industry regulations need to be made in order to fully implement the risk-based capital regime of CSE.

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[2] Directive 2002/87/EC of the European Parliament and of the Council of the European Union of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The FCD becomes effective for institutions for their financial year beginning on or after January 1, 2005. In a May 11th press release, the Basel Committee announced that the standardized and foundation approaches of Basel II will be implemented from year-end 2006, and the advanced approaches as of year end 2007.

Why We Care About Basel II

Given the impact of Glass Steagall[3] in the evolution of the U.S. financial services industry, at first glance one might ask why securities firms are concerned with a capital standard being developed for banks. Part of the answer, of course, is that enactment of Gramm-Leach-Bliley in November 1999 essentially abolished the remaining barriers between commercial and investment banking. Perhaps more importantly from the perspective of the major independent investment banks, the EU is in the process of implementing the Financial Conglomerates Directive ("FCD")[4]. The FCD will require that any financial institution with a substantial presence in the EU's capital markets either directly submit to consolidated supervision under the FCD or if a non-EU based institution, demonstrate that it is subject to an "equivalent" form of consolidated supervision in its home country. The consequences are not entirely clear if a non-EU financial firm is unsuccessful in demonstrating that its home country supervisor provides an equivalent form of consolidated supervision. EU officials have indicated, however, that such institutions will be required to "ring fence" their EU operations from those elsewhere, and may have to submit to having the United Kingdom's Financial Services Authority ("FSA") serve as their consolidated supervisor. This would have a substantial and deleterious impact upon global firms' ability to compete in the capital markets.

Notwithstanding that U.S. securities firms have been required to make risk-assessment reports to the SEC with respect to their material affiliates for more than 10 years[5], it did not appear likely that the EU would conclude that the existing regime of U.S. securities regulation was "equivalent" to the consolidated supervision standard to be implemented under the FCD. Partly in response, the SEC began developing two new regulatory structures that would clearly provide 'equivalent' consolidated supervision for securities firms and their affiliates, including holding companies. One such structure, Supervised Investment Bank Holding Company

[3] What is commonly known as Glass-Steagall is actually the Bank Act of 1933, which erected a wall between commercial banking and investment banking. Although eroded over the decades, it remained largely intact until enactment of Gramm-Leach-Bliley in 1999.

[4] Under the "Financial Conglomerates Directive" -- also sometimes referred to as the "Financial Groups Directive" -- a financial entity need not technically be a 'conglomerate' to fall within its terms.

[5] Rule 17h-2T – Risk Assessment Reporting Requirements for Brokers and Dealers.

("SIBHC"), was mandated by GLB.[6] The other framework is CSE[7], and the major independent U.S. investment banks[8] seem certain to register pursuant to that framework.[9] As the capital adequacy provisions of CSE are largely based upon Basel II, the major independent investment banks have a keen interest in Basel II, though as mediated through the mechanism of CSE.

Consequently, though they have long complied with varied local capital requirements at the affiliate level, major independent U.S. investment banks will soon be applying an international capital standard at the holding company, or group-wide, level for the first time. In the U.S., the SEC's capital requirements for broker/dealers are strict and comprehensive. However, this regime of local regulation contrasts significantly with major commercial banks, including those with securities subsidiaries, which have been subject to the Basel I standards on a consolidated basis for years. The day-to-day experience with Basel I and the leading role of their regulators was a key reason why commercial banks were involved closely in the development of Basel II. The major investment banks and the securities supervisors were, by comparison, "late to the table" with respect to key policy discussions with the framers of Basel II.

As investment banks began to comprehend the impact of Basel II across their global businesses, it became clear that the commercial-bank oriented approach, as reflected in the Accord's third consultative paper, could be problematic.[10] The composition of businesses typical of a major investment bank varies considerably from those typical of a traditional commercial bank – for example greater focus on short-term trading and secured financing, less (if any) emphasis on hold-to-maturity lending – and the investment banks observed that the apparent Basel II capital requirements for some of their key businesses were out of line with perceived risk and actual loss experience. Outsized capital requirements could cause firms to reduce activity (and by extension liquidity) in certain securities markets, so it was critical that the investment banks' concerns be addressed. I can report that firms have made significant progress

[6] Release No. 34-49831; File No. S7-22-03.

[7] Release No. 34-49830; File No. S7-21-03.

[8] The five institutions are: Bear Stearns; Goldman Sachs; Lehman Brothers; Merrill Lynch; and Morgan Stanley.

[9] In addition to the independent investment banks, we understand that a number of banks with substantial broker-dealer activities may also ultimately choose to register under CSE.

[10] The various drafts of Basel II have taken the form of "Consultative Papers," the most recent of which, Consultative Paper 3 ("CP 3") was published in April 2003. Last summer, the US Federal banking regulators published their version of CP 3 in the form of an Advanced Notice of Proposed Rulemaking ("ANPR").

in the last year in clarifying how the calculations should be made and conveying important technical flaws in the Accord through direct constructive discussions with Basel Committee members. Detailed technical discussions with officials of the Federal Reserve Board, the Federal Reserve Bank of New York, and the SEC enabled four large investment banks to refine their calculations and complete a comprehensive quantitative impact study that served as the basis for comments late last year on the Board's ANPR.[11] The recent formation of a task force by the Basel Committee and IOSCO to follow up on many of our concerns provides important evidence that the Basel Committee takes seriously the unique perspective of the investment banks.

Aspects of CSE

In addition to providing a means for the major U.S. investment banks to demonstrate consolidated supervision on an equivalent basis to the standard required under the EU's FCD, there are other key benefits of CSE. One is that the framework will permit securities firms registered under it to determine the regulatory capital for their broker-dealers by means of approved Value at Risk ("VaR") models.[12] This will better align capital requirements with the true risks of the securities business, with the added benefit of harmonizing the SEC's capital rules with global standards as represented by Basel II. Another key benefit is that firms that choose to register under CSE will have to demonstrate group-wide adherence to rigorous risk management practices. Reaffirming the old adage of "no pain, no gain," firms starting the application process report that the exercise is arduous, but also say that the result is sure to be further enhancement of regulators' confidence that there is a documented set of robust and resilient risk management practices and internal controls in place at these firms.

Although the CSE framework was published in final form only a few weeks ago, it was not created out of whole cloth, and there is a substantial history behind it. Among the most important milestones: firms began 17(h) risk assessment reports in 1992; also, a group of the largest firms active in the OTC derivative markets (these positions were largely carried outside a registered entity) created the Derivatives Policy Group ("DPG") in 1995, and committed to

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[11] Attached as appendix A is a copy of the comment letter on the ANPR.

[12] At the risk of over simplifying, a VaR model is a statistical technique used by firms to estimate how much money is at risk for a firm over a given period of time and with a specified degree of probability.

supplying the SEC with various monthly reports on their derivatives positions, and benchmarks for enhancing their risk management and internal controls. Subsequently the SEC created a regime for limited-purpose broker-dealers ("B/D lite") with the first entity registered under those provisions starting operations in 1999. Finally, in June 2001, the SEC's Market Regulation Division initiated a series of monthly meetings with major firms to review their risk reports in considerable detail. The SEC's Market Regulation Division should be congratulated for creatively building upon that background in developing CSE, and for recognizing the benefits of utilizing a form of "regulatory best practices" in incorporating Basel II for the capital adequacy element. CSE should be seen as part of a continuing evolution rather than an *ad hoc* creation.

Remaining Steps

First and most importantly, it is essential that we obtain an EU determination that the CSE's form of consolidated supervision is "equivalent" to that required by the FCD. Since the United Kingdom's FSA serves as the "lead" regulator for virtually all major U.S. firms operating in the EU, that body will be making the equivalence determination. It will do so based upon guidance set forth by the EU Banking Advisory Committee. Originally, the guidance was to be announced by the end of April 2004, with the FSA scheduled to make its first set of equivalence judgments by June 2004. We are concerned that these timetables have slipped. We ask that the Subcommittee and your colleagues on the full Committee monitor this situation carefully.

Second, if the goal of developing a new Capital Accord is to be realized, it is essential that all regulators coordinate and cooperate with their regulatory counterparts around the globe on implementation issues involving Basel II /CSE. Doing so will permit regulators to leverage their resources, help ensure that no entity is subject to duplicative or inconsistent requirements, and help ensure that supervisory responsibility is lodged with the supervisor or regulator best situated to exercise such responsibility. It would also help promote reciprocity, which is crucially important in the context of global capital markets.

Flexibility with respect to the timing and implementation of Basel II and CSE will be very important. U.S. securities firms, other than those that are part of an entity that is already subject to comprehensive consolidated supervision, have not been subject to Basel standards on a firm-wide basis, and thus have not been obligated to build a "Basel infrastructure." Thus, we

request flexibility as to which Basel standard applies to those firms, particularly during the period before Basel II is implemented. That flexibility is necessary in order to avoid the undue expense and burden of requiring that CSE applicants comprehensively implement a standard that is destined to be superseded in the relatively near future. Of course, such flexibility must be exercised in a manner that maintains consistency with international supervisory standards and avoids competitive disparities.

The collaborative process must continue for international capital standards to more fairly reflect the risks inherent in the investment banking businesses, without imposing large and unnecessary costs. Though we expect a "final" version of Basel II within weeks, we believe that our remaining significant concerns can be addressed through later interpretive guidance or amendments within the implementation timeframe. Perhaps most significant among many still open items is whether the SEC and other global regulators will recognize the reality that much of our risk-taking relates to trading, rather than banking, activities that meet both the spirit and the letter of the Basel Committee's definition of a trading book.

There is yet another – and fundamental – difference in the way banks and investment banks manage their activities, and we would ask regulators to be particularly aware of this distinction in the application of Basel II and CSE to investment banks. Banks and securities firms operate and report under substantially different accounting frameworks – banks generally accrue earnings and establish formula reserves, while securities firms mark-to-market and would expect to treat virtually all business lines as part of the trading book.[13] Mark-to-market accounting forces firms to immediately recognize changes in the risk profile of any position or business, and to take timely action to reallocate capital to address problems or opportunities. In contrast, banks maintain their assets at original book value, but establish reserves – generally on a formulaic basis -- to recognize concerns about credit erosion. If, in the application of Basel II or CSE to investment banks, regulators required investment banks to compute capital requirements for trading activities as though a part of the banking book, investment banks would be taking a "double hit" in the computation of their requirements.

[13] Appendix B is a one page summary of the current trading/banking book accounting for U.S. financial firms.

There are other critical areas for improvement, including methodologies used for the calculations for over-the-counter derivatives, securities financing transactions, and short-term unsettled transactions. We also support flexibility for regulators in their decisions about the models used in advanced measurement approaches to operational risk capital determinations to ensure that they fairly reflect the nature of such risks in investment banks. Our firms remain fully committed to devoting all the necessary resources, systems, and people to ensure a successful implementation of Basel II and CSE, and we are willing and eager to play an active part both in any fine-tuning of Basel II before the implementation date, and in any subsequent efforts to develop the next Capital Accord.

Implementation of CSE (or Basel II) presents many challenges to the firms expecting to be governed by it, and requires a very serious commitment of resources and staff. A challenge is also presented to the SEC, as the agency will be required to assume new responsibilities and develop a more comprehensive and intensive oversight of CSE firms. In our view, the SEC's Market Regulation Division and Office of Compliance, Inspections & Examinations have been doing a remarkably good job in meeting that challenge and developing into a 'prudential supervisor' comparable to any other in the global capital markets. That being said, we want to encourage the continuation of that process, since both the public and private sector must continually deal with the evolution of financial markets. To make that a reality will require that those units have the necessary resources, and we hope that the Subcommittee and your Congressional colleagues will ensure adequate funding for that purpose.

Lastly, certain rules that now limit the expansion of some business lines within U.S. securities firms and would continue to do so even for CSE registrants, need to be amended in order to make full use of the risk-based capital regime of CSE. In particular, we believe that amendments to existing margin requirements and position limits at a number of the self-regulatory organizations will be critical, thereby permitting an expansion of the OTC derivatives business within broker-dealers. Facilitating an expanded range of activity within the U.S. broker-dealer would reduce the number of different entities through which firms book activities, resulting in a variety of benefits and efficiencies for both affected firms and their customers.

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We very much appreciate the Subcommittee's interest in the adoption and implementation of Basel II. We look forward to working with Congress, the Administration, and regulators on finalizing and implementing the new Capital Accord, particularly as it is a key component of the CSE framework.

Thank you very much.

Appendix A

Ad Hoc Working Group of U.S. Investment Banks

ATTN: Docket No. R-1154
Advanced Notice of Proposed Rulemaking: Risk-Based Capital Guidelines;
Implementation of New Basel Capital Accord

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue
Washington, DC 20551

Re: Advanced Notice of Proposed Rulemaking Comment Letter, Docket No. R-1154

Four large U.S.-based global investment banking firms formed an Ad Hoc group to undertake a study of the impact of the ANPR on their firms. This ad hoc group represents a majority of the U.S.-based internationally active investment banks. This group is pleased to offer you comments on the Advanced Notice of Proposed Rulemaking: "Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord" ("ANPR Basel II"). Although the Federal Reserve's rules may not directly impact the four firms, they are important to us as a leading example of Basel II implementation in the United States.[1] Our comments are based largely on the impact study that was conducted, which indicates that for many of our core activities Basel II prescribes capital requirements that appear to be excessive relative to risk and loss experience. As a result of this study, we believe there are a few key modifications and clarifications that can address the concerns we have identified and foster a more appropriate risk-based capital regime.

In particular, based on the pro-forma calculations of the four investment banks which measure the impact of moving from Basel I to Basel II, we have identified a number of areas in which the results of the calculation have been impacted materially by (1) substantive differences in trading book versus banking book treatment for similar asset classes, (2) the proposed treatment of OTC derivative transactions, and (3) differing interpretations of the Basel I accord across jurisdictions, particularly in regard to Securities Financing Transactions.

1. **Trading Book / Banking Book treatment**

   We note that 3 of our 4 firms do not have a "banking book" per se, and solely utilize trading book, mark-to-market approaches in both financial reporting and risk management practices. (We also note that the firm with a banking book follows trading book approaches where deemed appropriate). We observe that there is substantial divergence between the risk weighted assets that are generated

[1] We note that the Securities and Exchange Commission has issued a proposal that provides, among other things, for consolidated supervision using Basel II standards. We intend to comment separately on this proposal.

for similar asset classes depending on whether a banking book or a trading book methodology is used. In particular, the choice of methodology generates significantly different risk weighted assets when dealing with trading portfolios of corporate loans and pools of purchased and originated assets that are being warehoused in preparation for securitization. We recommend that the Federal Reserve apply a standard consistent with that found in CP3 of the Basel II Capital Accord[2] when determining whether trading book or banking book treatment is warranted, the key requirements of which are mark-to-market accounting and intent to sell. We believe that this treatment is appropriate since it reflects the way that the firms actually manage the risks of their respective businesses. In assessing capital levels for these trading book activities, we believe the Basel II Accord appropriately provides for review and approval of models for assessing risk; any concerns about the adequacy of capital levels for these activities should be alleviated through testing the effectiveness of the models. Additionally, utilizing a banking book approach would require considerable expense to develop systems and collect the data necessary to calculate expected and unexpected losses on a par basis, while yielding no tangible benefit relative to current risk management practices.

2. **Securities Financing Transactions – Interpretative Differences**

The results of the study revealed that substantive differences in interpretation of the Basel I capital accord yield materially different results as to the impact of moving from the Basel I capital accord to the Basel II capital accord. In particular, the treatments of repo-style transactions and the recognition of collateral specified under Regulation Y versus that accepted by the Financial Services Authority (FSA) in the United Kingdom yields results so divergent as to change directionally the impact of moving from Basel I to Basel II for the firms surveyed in the study.

a. **Treatment of repo-style transactions.** The treatment of repo-style transactions specified under Regulation Y requires firms to apply a 20% risk weight on the collateralized portion of any government-collateral reverse repurchase transaction in which the value of the outstanding contract is greater than the value of collateral securing the loan, and to apply the counterparty risk weight to the unsecured portion.[3] Conversely, the FSA Basel I approach uses a replacement cost methodology that requires firms to apply risk weights only to the unsecured portion of repo-style transactions, and not to the secured portion. These different approaches result in directionally different movements when measuring the impact of progressing from Basel I to Basel II, as applying a 20% risk weight to the secured balance of repo-style transactions results in very large risk weighted assets.
b. **Definition of eligible financial collateral**. Along a similar vein, the definition of eligible financial collateral is far more restrictive under

[2] See 3rd Consultative Document, Part 2, Section VI.A – Definition of the Trading Book.
[3] Regulation Y, Pt. 225, App. A, Attachment 3, Section C.2.c, page 221, 1/1/03 edition

Regulation Y than it is under the FSA approach. Specifically, collateral in the form of corporate obligations (i.e., corporate bonds, convertible securities, and equity securities) takes a 100% risk weight under Regulation Y, whereas it is treated as effective credit risk mitigation under the FSA approach, which does not haircut financial collateral. The impact of this difference in interpretation is substantial – for example, the entire book of Regulation T compliant margin debits would be considered equivalent to a book of unsecured loans under the Regulation Y interpretation, thus attracting a 100% risk weight. Under the FSA approach, a margin loan, which is typically substantially overcollateralized, would generate zero risk weighted assets. Similarly, a repo-style transaction that uses corporate bonds or convertible securities as collateral is treated as an entirely unsecured loan under Regulation Y, which generates high risk-weighted assets relative to the economic risk and structure of the transaction.

3. OTC Derivatives

We endorse the positions expressed in the joint comment letter submitted on November 3, 2003 by the International Swaps and Derivatives Association and The Bond Market Association ("ISDA/TBMA"). Specifically, as argued by ISDA/TBMA, both the Basel I and Basel II treatments of OTC derivatives are unreasonable insofar as the add-on levies an effective "tax" on the notional amount of transactions, which can only be ameliorated through a decrease in volume. We support the ISDA/TBMA proposal that the treatment for OTC derivatives be revisited promptly, and recommend that the treatment for transactions that are economically similar and exhibit similar risks, such as repo-style transactions and OTC Derivatives, should receive uniform treatment, e.g., utilizing a potential exposure or expected exposure methodology, under the New Accord and ANPR.[4]

Additionally, our firms observed that the proposed treatment for OTC derivatives has the effect of raising the capital requirements for all of the firms that participated in the study when moving from Basel I to Basel II, primarily due to the removal of the 20% risk weight on OECD banks, the removal of the 50% cap on non-bank counterparty risk weights, and the addition of a maturity adjustment to the risk weight function. Further, certain types of collateralized derivative transactions, e.g., sold covered options, do not entail any credit risk but, illogically, generate credit risk-weighted assets under the proposed methodology. It is our opinion that the risk weighted assets generated by the ANPR Basel II methodology do not on the whole reflect the economic risk associated with the business, and in certain particular cases these risk weighted assets are generated in cases where no credit risk actually exists.

a. **Proposed calculation raises capital requirements across the industry.** The proposed calculation raises capital requirements relative to Basel I

[4] See ISDA/TBMA joint comment letter regarding the ANPR, November 3, 2003, pages 7-8.

due to the removal of the 20% risk weight for OECD banks and the 50% cap on non-bank counterparty risk weights, as well as the addition of a maturity adjustment to the risk weight function. Based upon the provisional probabilities of default and loss given default parameters employed in our quantitative study, capital requirements begin to increase for any OECD bank counterparty rated in the single "A" range and below, while requirements increase for non-bank commercial counterparties rated in the "BBB" range and below, based upon a 1-year maturity. These requirements increase even more for derivatives with greater than one year maturity.

b. **Covered trades.** We refer to forward and options transactions in which the underlying instrument is pledged and held in custody by the bank in sufficient amount to fully satisfy the settlement or exercise obligation as "covered trades." An example of such a trade is an equity call option in which the counterparty sells an option and simultaneously pledges to the bank the amount of the underlying shares deliverable under the option terms. Because the value of the underlying security will move in tandem with the value of the derivative and the bank is fully secured, no credit risk arises from the transaction. However, credit risk weighted assets are generated due to the fact that the methodology requires that equity collateral be haircut by 25% and does not account for the fact that any future movement in the exposure related to the derivative will be matched entirely by movements in the value of the underlying security held in custody.

We are pleased to have this opportunity to comment on the ANPR and would be happy to discuss our views at greater length. For additional information, please feel free to contact us at your convenience.

Sincerely,

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APPENDIX B

Current Trading/Banking Book Accounting for U.S. Financial Firms

	Securities Firms	**Banks (Mixed Attribute Model[1])**
Trading Book	All financial instruments[2] held in inventory (longs and shorts) must be accounted for at fair value, with changes in fair value recognized in earnings.	Loans, derivatives, securities, and other financial instruments held for trading purposes must be accounted for at fair value, with changes in fair value recognized in earnings.
Accrual Book	Does Not Apply	Loans and loan commitments not held for trading are accounted for at cost, less an allowance for potential credit losses. Securities held for investment purposes are also accounted for at cost, provided management has the intent to hold to maturity. Selling such securities prior to maturity is frowned upon and only allowed in limited circumstances. Only when sold or impaired are changes recognized in earnings.
Available For Sale	Does Not Apply	Securities available for sale (generally for asset-liability management purposes) are accounted for at fair value, but instead of the changes recognized in earnings, changes are recognized through the equity accounts. Only when sold or impaired are changes recognized in earnings.

Derivatives

Derivatives are accounted for at fair value, but banks utilize hedge accounting[3] to a considerably greater extent than securities firms, owing to the mixed attribute model they follow. Securities firms' use of hedge accounting is generally limited to their long-term debt, which is not permitted to be accounted for at fair value.

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[1] Under a mixed attribute model, a bank accounts for financial instruments depending on its intent with respect to the instrument.

[2] For securities firms, the term "financial instruments" includes loans, loan commitments, financial guarantees, securities, and derivatives.

[3] Generally speaking, hedge accounting is the ability to offset changes in the fair value of the derivative against changes in the fair value of the hedged item, provided the hedge meets a number of effectiveness tests. Hedge accounting is a complicated subject (the U.S. GAAP rules are over 900 pages). FASB has noted that the rules would be much shorter and simpler if all financial instruments were accounted for at fair value.

Bank of America

Testimony of Joseph Dewhirst

Treasurer

Bank of America Corporation

Before the

House Financial Services Subcommittee on Financial Institutions

Hearing on "The New Basel Accord: Private Sector Perspectives"

June 22, 2004

Introductory Comments

- Chairman Bachus, Ranking Member Sanders, members of the Subcommittee, on behalf of Bank of America, I thank you for the opportunity to provide our comments regarding the Basel II framework. I am Joseph Dewhirst and I am the Corporate Treasurer of Bank of America.

- Bank of America, with over $1 trillion in total assets, provides banking, investing, corporate and investment banking services and financial products to individuals and businesses across the United States of America and around the world. Within the U.S. itself, we have full-service consumer and commercial operations in 29 states and the District of Columbia.

- I intend to briefly summarize Bank of America's position on Basel II, including a review of progress to date, to discuss the implications of Basel II for the competitive environment, and to outline areas of continuing concern within each of the three pillars in the framework.

General Position

So let me begin by summarizing Bank of America's position on Basel II.

Direction

- The overriding concern of bank regulators is the safety and soundness of the banking industry. Bank management and shareholders naturally share this concern.
- Capital is a buffer against loss; and adequate capital is critical to the safety of a bank. It is sensible for bank management and for bank regulators to assess the adequacy of bank capital by looking at risk of loss.
- Bank regulators worldwide used Basel I to formalize the view that capital allocation should be risk-based and to define a method for assessing both risk and capital adequacy. This Capital Accord was, in our view, a major step forward in rationalizing the assessment of the capital adequacy of banks.
- Basel I was, nevertheless, only an initial step – an approximation to a true risk-based system. As the industry has developed more sophisticated methods for measuring risk, often dependent on computing power that has become available only during the last decade, there has been a growing need for more advanced regulatory capital requirements that more accurately reflect the increasingly complex risk profiles of the industry's largest banks and securities firms. Basel II is that more advanced approach.
- We strongly support the Basel II initiative, including the three-pillar paradigm of minimum capital requirements, supervisory review and market discipline as part of a comprehensive risk-based capital approach. We support the efforts to better align regulatory capital requirements to underlying economic risks, to encourage better risk measurement and management processes and to promote international consistency in regulatory standards.

Progress made

Next, let me give a brief assessment of progress made from our perspective:

- Our general view is very positive. Significant progress has been made toward a broadly accepted and reasonable basis to measure capital adequacy. Several of the more significant concerns of Bank of America were addressed as the Basel II proposals evolved from CP1 to CP3 and ultimately the US ANPR. The most important of these were the prescriptive nature of the proposals, the treatment of expected loss and the calibration for retail portfolios.
- We commend the Agencies' leadership in this process. While time-consuming and sometimes contentious, the consultative dialogue the Agencies have maintained with the industry has been mutually beneficial and has improved both the transparency of the process and the quality of the result.
- There are, nevertheless, several technical issues tied to the details of the calculations that still cause concern. As always, the devil is in the details. So we recognize that the Accord will continue to evolve. More important, the US Agencies are about to begin the fourth Quantitative Impact Study in the fall. We understand that another QIS may be scheduled for 2006. The additional year of impact studies and subsequent parallel reporting will, almost certainly, reveal areas requiring further research and modification to the rules. But we have every confidence that these details will be resolved before the final implementation date.

Operational risk

Some in our industry have raised questions about the capital requirements for operational risk.

- Bank of America strongly supports the Pillar I capital requirements for operational risk. The operational risk approach strengthens the overall risk-based capital framework, creates greater transparency than Pillar II alternatives and aligns the regulatory capital with industry best practice.
- We believe the Advanced Measurement Approach, which leverages the flexibility of internal methods in association with supervisory review, will allow for the most appropriate measurement and management of operational risk.
- We have already implemented explicit capital charges within our internal systems for operational risk. While some work remains, we believe these models are almost fully compliant with the AMA requirements. It would be disingenuous for us to take any position other than supporting the Pillar I approach within the Basel II framework.
- One need only look at recent history of the industry to find ample evidence that operational risk can be significant. It deserves the same rigor of analysis, governance and risk management process that is employed in the credit and market risk disciplines.

Impact on Competitive Environment

Let me turn next to the impact of Basel II on the competitive environment.

- We believe that changes in capital requirements will not materially alter the competitive landscape. The proposals will have a limited effect on the behavior of the banking industry. In particular, well-managed banks will not see significant change. To the extent that change does occur, it will follow from more prudent management of risk and more rational allocation of capital.

- Bank of America believes that good risk management provides a competitive advantage, irrespective of the regulatory capital framework. Therefore, we have invested significant time and resources to develop industry leading risk management processes and economic capital models.

- Correspondingly, Bank of America already manages its business activities on the basis of economic (or risk-based) capital, which is the core of Basel II. We believe that these tools enable us to make better risk and return decisions, enhancing the return on our capital investment. We apply this approach to pricing decisions, strategic planning processes, portfolio management activities, management reporting metrics and incentive compensation decisions. We already manage based on methods broadly consistent with Basel II. So our behavior is not likely to change in any material way.

- Banks that are not required to implement Basel II may elect to do so based on their own cost-benefit analysis. Since the new requirements will not alter the behavior of the more advanced banks with existing economic capital processes and because they are optional for other banks, we

expect them to have no direct adverse effect on the competitive environment.

- Concerns have been raised regarding the prospects for industry consolidation as a result of Basel II. Of course, there are economies of scale in risk management. Good risk management has a cost, and it is easier to spread that cost over a larger base of assets. So at the margin, by encouraging good risk management, Basel II may encourage consolidation. But it will be insignificant compared to other drivers of consolidation, such as the economies of scale around product development, systems, and staffing as well as the benefits of diversification across business and geography.

Remaining Technical Concerns

As indicated, we have a number of technical concerns, which I will summarize here very briefly.

Pillar I: Capital Requirement

Under Pillar I, we have a number of concerns related to the capital requirement for credit risk:

- Proposed treatments of Expected Loss fail to recognize that banks already set product margins not only to compensate for expected loss and but also to earn a return. Capital for expected loss is not necessary.

- Caps on the resources considered as capital should be discarded. In particular, there should be no limit on the amount of reserves that qualify as capital, as the full amount of reserves is available to cover losses.

- The current approach to counterparty credit risk, which requires add-on factors for potential future exposure, is inconsistent with the best practices of leading banks.

- The current approach for recognizing the risk mitigation of credit derivative hedges is ineffective because it grossly overestimates the probability of a loss event.

- The treatment of maturity is particularly important for capital markets transactions. The current approach fails to recognize the reduced risk of assets with short-term tenors.

- Work remains to be done on the calibration of capital for mortgages and other retail assets. Through the use of conservative floors on the probability of default and loss given default, the current approach assumes that there is inherently more risk in these assets than seems justified.

Pillar II: Supervision and Coordination of Home & Host Regulatory Authorities

Under Pillar II, we have concerns related to home and host issues:

- The complexity of the new rules poses a particular challenge for international banks regulated in multiple jurisdictions. The Committee has adopted the principle of lead supervision, where the regulator in the bank's home country will coordinate information requests from host country regulators and play a leading role in the approval and validation of the capital models.
- We appreciate the elaboration of these high level principles. However, we are quite concerned regarding their implementation in practice.

Pillar III: Disclosure Requirements

Under Pillar III, we have a concerns related to disclosure requirements:

- We agree that disclosure has an important role to play in the effective implementation of the Accord. We appreciate the steps taken to reduce the amount of required disclosure, but we believe that the disclosure requirements remain excessive. The risk of misinterpretation of this complex and detailed information will far outweigh its potential benefit. Transparency would be better achieved by the clear presentation of more limited but important information than by the publication of large amounts of data.

We provide detail regarding these and other concerns in an attached written appendix.

Summary

In closing, let me again thank you for this opportunity to express our views. Let me assure you that we strongly support the objectives of Basle II, and we have been pleased with the process and progress to date. While we recognize outstanding issues, we believe these issues can be resolved satisfactorily. Finally, we believe that Basel II will encourage better management of risk and more rationale allocation of capital in the banking industry.

Appendix I

Areas of Significant Progress

- One of our early concerns was the prescriptive nature of the proposals when CP3 was published. We commend the Agencies for adopting a principle-based approach in crafting the Advanced Notice of Proposed Rulemaking and Draft Supervisory Guidance for implementation in the US. We believe only a principles-based approach will be flexible enough to accommodate the continuing evolution of risk management and the development of new financial products.
- We were also quite concerned regarding the treatment of expected loss in the overall framework. The committee's decision to eliminate the capital requirement for expected loss was a significant advance toward a true risk-sensitive capital framework. With the proposed elimination of expected loss, the framework for the measurement of risk is now more closely aligned with the best practices of the industry. Unfortunately, the proposed treatment also includes offsetting changes in the determination of actual capital and fails to address longstanding issues regarding regulatory capital definitions and limitations on qualifying capital. We continue to believe these issues warrant further consideration and modification before final implementation.
- We also felt that the calibration of capital requirements for retail portfolios was not aligned with the underlying economic risks. Without getting into too much technical detail, the calibration did not adequately represent the level of diversification inherent in a retail portfolio. The Committee has resolved this issue with a new calibration for credit card portfolios which is much more in agreement with industry experience.

Appendix II

Details of Remaining Technical Issues

Treatment of expected losses

- The recent proposal to remove expected loss from the capital requirement does indeed reduce the divergence between the industry and regulatory measures of risk. However, the proposal also contains a deduction from actual capital for expected loss (EL). The two treatments of EL – as a component of the risk measure or a deduction from actual capital – are ultimately equivalent. Both treatments fail to recognize that banks consider expected loss to be a cost of doing business and set product margins to not only compensate for expected loss and but also earn a return on capital.

- Our formal comment recommended the adoption of the industry approach, which recognizes that product margins are set so that FMI will compensate for EL and therefore neither adds EL to the capital requirement nor deducts it from capital. If the Committee prefers to retain an explicit treatment of EL, this can best be accomplished either by restricting the EL deducted from reserves to that of non-performing loans or by allowing explicit estimates of FMI to offset EL, subject to appropriately conservative haircuts.

- The notion of caps or restrictions on the amount of resources that may be considered as capital should be discarded. In particular, there should be no limit on the amount of reserves that qualify as capital, as the full amount of reserves is available to cover losses.

Counterparty Credit Risk

- We are aware that the Basel Committee and IOSCO have established a working group to review the method for calculating the capital charge for counterparty credit risk. The current approach that requires add-on factors for potential future exposure is inconsistent with the best practices of leading banks.

- Regulatory capital should move away from the current add-on approach in favor of exposure measures based on internal models. Banks use well established market risk models to estimate exposure profiles for each counterparty and account for cross product netting agreements, diversification across risk factors, and applicable collateral agreements. These models are implemented with the same standards of accuracy as market risk models and already subject to stringent model validation processes.

Limited Recognition of Credit Risk Hedging

- The current approach for recognizing the risk mitigation of credit derivative hedges is ineffective. It attempts to capture the benefits of credit risk hedging and guarantees through substitution of the default probability of the guarantor for that of the borrower when determining risk weightings. It fails to recognize that the obligor and the guarantor must both default for a bank to experience a loss on a hedged exposure. The odds of such an event are considerably less than a default of either entity in isolation.

- We believe this approach is far too conservative and should be changed. The proposal is inconsistent with the stated objective of promoting better risk management practices and could send inappropriate signals regarding the value of risk mitigation. Consider the case of an exposure to a AA rated industrial company which is hedged in the credit derivative market with a AA rated bank as the counterparty. Under the proposed substitution approach, the risk mitigating value of the hedge would simply not be recognized.

- Bank of America supports the approach for reflecting credit hedges developed by the Federal Reserve. We believe the FRB approach can be implemented with the same standard of accuracy as any other element of the AIRB approach.

Limitations in maturity adjustments

- The treatment of maturity is particularly important for capital markets transactions. The current approach fails to distinguish the risks of assets with short-term tenors. We believe these restrictions should be removed and that the maturity adjustment should be open-ended to be consistent with industry practice.

Retail Calibration

- Recently, the committee has addressed this concern for credit card portfolios. Unfortunately, concerns remain regarding the calibration of capital assignments for mortgages and other retail assets. These concerns center around the use of conservative floors on the default probability and loss given default parameters and the overall level of correlations on these products.

Appendix III

Details of Disclosure Issues

- We agree with the importance of market discipline and believe that disclosure has a very important role to play in the effective implementation of the Accord. We appreciate the steps taken to reduce the amount of required disclosure. Unfortunately, the disclosure requirements are still grossly excessive. The risk of misinterpretation of this information and the burden its distribution will place upon banks far outweigh its potential benefit.

- Transparency is better achieved by the clear presentation of important information than by the publication of large amounts of data. The possibility for unintended consequences of excessive disclosures should be given greater consideration. Our local examiners have the historical context and sufficient knowledge of the institution to correctly interpret this information. Many market participants, on the other hand, lack the same depth and breadth of understanding. Rather than encouraging market discipline, the proposed volume of disclosure will slow the absorption of information by the market and increase the likelihood of inappropriate or contradictory conclusions by investors.

- The effort required to amass the sheer volume of data, prepare it for presentation and provide explanatory comments will make it nearly impossible to meet the deadline of 30 days following quarter-end for Call Report and SEC filings that will be effective by the time Basel II is implemented. It is essential that investors be provided with the appropriate level of information at the right time. Under the current Basel I regime, we are able to present risk-based capital ratios and supporting detail when we announce earnings. The proposed level of disclosure is inoperable within that same timeframe. As a result, the presentation of capital adequacy information will be delayed and the timeliness of our disclosures will suffer.

- Corporations have a valuable role to play in summarizing and analyzing data for their shareholders. The Agencies, in association with the industry and the investor community, should identify a smaller subset of key disclosures that will appropriately convey a bank's risk profile without inundating the user with irrelevant information or risking misinterpretation. Any remaining disclosures should be left to the judgment of the institution based on the demands of their investors, the relevance of the information to the current financial condition of the bank and the state of the overall economic environment.

Testimony of
Steven G. Elliott
Senior Vice Chairman
Mellon Financial Corporation

Before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representative

June 22, 2004

It is a pleasure to testify today before this Subcommittee on the potential impact of Basel II on Mellon Financial Corporation and, more broadly, on the ability of U.S. banks to serve their customers and investors. It was an honor also to appear last June before this panel on this topic. I am grateful for the Congress' continuing interest in the Basel Accord. Your focus on this sometimes overwhelmingly technical rule has ensured attention by regulators at home and abroad on what the changes to the international risk-based capital rules mean on the most important level: the ability of individual and corporate customers to get what they need at a price they like from a vibrant U.S. financial services industry.

Mellon Financial Corporation is one of the world's leading providers of financial services, with extensive product capabilities that it has offered to its customers for more than 130 years. Headquartered in Pittsburgh, Mellon provides its services to institutions, corporations and high net worth individuals, providing institutional asset management, mutual funds, private wealth management, asset servicing, human resources and investor solutions, and treasury services. Mellon has approximately $3.6 trillion in assets under management, administration or custody, including more than $675 billion under management.

As a specialized financial institution, Mellon has a special concern with a particular aspect of the Basel II proposal: the new regulatory capital charge for operational risk. We think much in the proposed new international capital standards and in the way regulators here plan to implement them are quite good. Indeed, the current risk-based capital standards need a wholesale rewrite. However, the overall need for new capital standards should not distract from the critical importance of getting the details right. The operational risk charge could well have a dramatic and adverse competitive impact on specialized banks. Trillion-dollar diversified banks can offer a broader range of services to their customers. However, that is often done at a cost – the inability to focus clearly on individual clients who want a high degree of expertise in areas like asset management and payment processing.

Mellon is grateful to you, Chairman Bachus and the leadership of this Subcommittee, along with that of the Financial Services Committee under Chairman Oxley and Ranking Member Frank, for your continuing attention to the many problems with the operational risk charge, particularly its potential adverse competitive impact. You have rightly pressed the Federal Reserve to analyze the Accord's competitive impact. We understand that the Board is currently studying the operational risk-based capital charge's competitive impact. Mellon is of course happy to cooperate in any way that would help in bringing about the right result. The Board has also completed a study on the rule's impact on mergers and acquisitions – a key question to ensure that the nation's banking system doesn't become too consolidated. I would argue that there is a direct correlation between capital and business activity. If it wasn't, it's hard to understand why all of the

U.S. and international banking agencies have devoted so many years of hard work to the Basel II rewrite. This is far from a technical exercise, but rather one with profound implications.

Today, I would like to emphasize:

- the need for the Basel rules – and especially the U.S. version – to rely on effective prudential regulation and enforcement to address operational risk. An arbitrary regulatory capital charge for operational risk like the one now proposed will have adverse market consequences that will ultimately undermine customer service;

- the risks posed by the operational risk capital charge, even in the "advanced" version proposed in the U.S. We continue to believe that ongoing improvements to operational risk management will be undermined by the proposed capital charge, creating perverse incentives for increased operational risk, not the decrease regulators desire and on which Congress should insist; and

- the importance of other changes to the U.S. version of Basel II to ensure that our banks remain competitive and focused on key market needs. This means a review of the complex credit risk standards for specialized banks. A hard look at the proposed retention of the leverage standard and the criteria for determining who is a "well-capitalized" bank is also vital, since these standards govern only U. S. banks and could have adverse competitive impact if retained.

As I shall discuss in more detail, Mellon respects the desire by the regulatory agencies in Basel and the U.S. to advance operational risk management. That's why the Financial Guardian Group, to which Mellon belongs, has answered the U.S. regulators' request for a detailed and enforceable safety-and-soundness standard with a comprehensive proposal. I have attached that proposal to this statement for your consideration. The U.S. regulators have also asked us if a safety-and-soundness approach (called Pillar 2 in the Basel II framework) could be paired with improved disclosure (Pillar 3) to back up regulatory enforcement with market discipline. We took that request very seriously and provided a detailed proposal which I have also attached to my statement. The Federal Reserve Board thanked us for our submission, but does not appear to be pursuing it as an option.

Is a capital charge for operational risk a detail that can be worked out later as regulators finalize the capital rewrite? I don't think so since it would be fairly costly. Application of the OR charge would obligate us to review our business model and incorporate a regulatory capital charge that bears little reflection to the real risks that we run.

What is operational risk?

Before I go too far into the complicated details of Basel II and the proposed capital charge for operational risk, I think I should first explain operational risk. It's an important risk, and one to which Mellon's senior management dedicates much attention and considerable resources. Operational risk – OR, for short – is the risk of systems or human failures, as well as the impact from natural or manmade disasters like hurricanes or terrorist attacks. The bank regulators have decided to include in their OR definition "legal risk". This type of risk includes the risk resulting from tort liability, securities suitability standards, and the laws against loan and employment discrimination-among many others. These same legal standards, however, do not apply in many other countries or legal systems. One must question why US regulators would agree to a capital charge for US banks arising from laws and regulations unique to our country that are designed to achieve our own social objectives- especially given the requirement for reserves against material legal risk. Furthermore, these are laws that have no known bearing on any bank's failure. In cases where a bank may be subject to legal risk, securities law requires full disclosure of material matters, thus the operational risk proposal would have no new impact on market discipline. Moreover, litigation loss history provides limited insights into future losses, creating significant challenges to modeling. Since legal losses are typically closely linked to individual events and circumstances, the use of external data is particularly inappropriate for legal risk.

The bank regulators have decided to exclude "reputational risk" – that is, violations of customer expectations, regulatory requirements or social expectations that damage investor or customer confidence. I'm not at all certain that the regulatory OR definition – legal risk in, reputational risk out – is the correct one, but I know that it is extremely difficult to quantify much that the regulators call operational risk. Without reliable, tested and industry-standard models for defining and quantifying operational risk, a capital charge to offset a risk that cannot be clearly quantified doesn't make sense.

How Do Banks Now Handle OR

Operational risk is covered in two ways. First, through critical risk management efforts that include investments in operational risk infrastructure, systems, processes and people (compliance, audit, legal, risk management) as well as contingency planning, disaster preparedness, back-up facilities and redundancies (the latter would help deal with a 9/11-type risk). Second, OR is ordinarily covered by revenues, reserves, insurance and risk mitigation. These latter techniques are particularly helpful for managing "expected loss" (EL). This is, for example, the risk that we know that a computer will make mistakes a certain percentage of the time or the likelihood that an employee will misplace an order or misread a trade. We know how to anticipate and guard against these risks, and we have a range of tested systems in place to address them. The list of bank problems circulated in the regulators' discussion of OR that tries to rationalize the capital charge includes not a single incident of expected loss risk. The Basel Committee earlier this year rightly decided to take expected credit loss out of that aspect of Basel II, focusing the rule instead only on unexpected loss (UL) because of a comparable problem with the role of expected credit loss on bank failures. However, the proposed new capital charge

for OR – even in its most "advanced" form – still covers both EL and UL. Since EL is well handled now and UL – the risk of a 9/11 attack, for example – is immeasurable, the capital charge is deeply flawed.

Additional Problems with a Regulatory Capital Charge

In my testimony before this panel on June 19, 2003, I went into considerable detail on the problems with the operational risk-based capital (ORBC) proposal. Nothing in the advance notice of proposed rulemaking published by the U. S. agencies thereafter addressed any of these fundamental flaws, although we appreciate that numerous questions about them were posed. Since then, the Basel Committee has made some changes to the final version of the rules, which are expected later this week in final form. However, these changes we anticipate will fail to reflect the fundamental problems in the ORBC proposal – problems that can only be fixed by eliminating the proposed capital charge from "Pillar 1" regulatory capital standards and substituting strong supervisory standards and enhanced disclosures. Mellon is not alone in its opposition to a Pillar 1 capital charge, although specialized banks will be adversely affected by it. Even banks that may broadly support the concept of a regulatory capital charge – which we don't – have problems with how an ORBC requirement will work in practice. Other institutions that, like Mellon, strongly oppose a Pillar 1 charge, based on their public comments, include Wells Fargo, MBNA, Washington Mutual, Merrill Lynch, Lehman Brothers and Goldman Sachs.

Numerous commenters – including several Federal Reserve Banks and the Federal Reserve Bank of New York's Foreign Exchange Committee have also noted serious problems with a quantitative approach to operational risk. Indeed, the Federal Reserve Bank of Chicago filed a comment with the Basel Committee making clear the numerous problems with an operational risk capital charge.[1]

The Federal Reserve Bank of Richmond also filed a comment noting that operational risk can be "[a] difficult risk to quantify and can be very subjective."[2] The Federal Reserve Bank of San Francisco has noted, "[a] key component of risk management is measuring the size and scope of the firm's risk exposures. As yet, however, there is no clearly established, single way to measure operational risk on a firm-wide basis."[3]

I would like to summarize key problems with the current version of the ORBC proposal beyond the basic one that capital can't be assessed for risks no one can define or measure in a uniform, industry-wide way. They include:

- An ORBC charge creates perverse incentives to effective OR management. The "advanced measurement approach" (AMA) proposed by U.S. regulators

[1] *Federal Reserve Bank of Chicago Response to BIS Capital Proposal*; Federal Reserve Bank of Chicago; May, 2001.
[2] *"The New Basel Accord" Second Consultative Package, January 2001*; Federal Reserve Bank of Richmond; May 30, 2001.
[3] *FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, January 25, 2002.

is designed to fix the acknowledged flaws in the more simple ORBC options included in the original Basel II proposal, but it still doesn't resolve this serious problem. For example, insurance isn't fully recognized, even though the "loss data collection" exercise conducted by Basel last year showed that insurance reimbursed banks for the vast majority of expected and unexpected operational losses.

- There will likely be major disparities in the way regulators in different countries will impose the ORBC charge because there is no accepted definition or way of measuring OR. The Basel Committee has tried to address this through a "hybrid" approach to deciding which regulator sets the capital charge for which subsidiary of an internationally-active bank, but this compromise leaves many important issues unresolved. Since host-country regulators can fundamentally set whatever ORBC charge they want, they could well set ORBC in a way that advantages their own banks at the cost of those seeking to enter their markets. This can particularly disadvantage U.S. banks because of the much stricter and thorough US regulatory environment.

- These potential competitive problems are exacerbated by the much more encompassing supervisory and enforcement roles of U.S. bank regulators than the approach adopted in many other nations. Japanese banks, for example, were deemed by the Japanese regulator to comply with their regulatory capital standards for over a decade despite objective analysis which showed that serious credit risk problems meant that those banks did not comply. In the EU, bank regulators rely on auditors, not their own examiners, to determine if banks meet capital standards. The auditors, in essence, wear two hats – working for their bank clients that pay them and the regulators that rely on their reviews, clearly not a good situation under Sarbanes-Oxley and bound to raise questions in this post-Enron environment. Thus, non-U.S. banks can stay open for business and compete vigorously against U.S. banks even if comparable conditions for a U.S. bank would likely lead to severe sanctions under Prompt Corrective Action procedures.

- Reliance on untested, ill-understood models to set ORBC creates "models risk." That is, all banks will set capital in the same way even if their risks vary dramatically – what experts call "endogenization" and what I call the herd mentality. Reliance on diverse models tested by bank supervisors on a case-by-case basis ensures that different circumstances are appropriately reflected. Improved disclosure would ensure accurate market understanding of these differences and impose discipline on them where needed.

- ORBC established through arbitrary regulatory capital standards will adversely affect specialized banks competitively because the many non-banks against which they compete in key business lines remain outside the Basel capital standards. This remains true despite the "consolidated supervised entity" capital rule recently adopted by the Securities and Exchange

Commission because the Basel capital standards will apply only at the parent company level for some large non-banks, with many remaining outside this framework and, thus, free from regulatory ORBC. Further, the SEC's capital charge for covered investment banks is substantially different than the charge imposed on U.S. banks and the capital charge is offset in part by a huge drop in regulatory capital for broker-dealers.[4]

Credit Risk Concerns

In general, Mellon supports the proposed rewrite of the credit risk-based capital (CRBC) standards. We unequivocally support their goals – better correlation of regulatory capital with economic capital (that is, the amount of capital market forces demand to protect against risks). Differences between regulatory and economic capital can have profound market impact — companies that have to hold undue amounts of regulatory capital because of rules that don't apply to their competitors must meet investor profit expectations because their basic "return on equity" equation is skewed against them and in favor of competitors with a smaller capital base. Conversely, banks that don't hold enough economic capital for high-risk positions and still comply with their rules can take business away from firms subject to market discipline. This, of course, puts both these banks and the FDIC at undue risk.

However, a balance must be struck between getting regulatory capital precisely right and the complexity and burden associated with doing so. Basel II is a very costly proposition. An April PriceWaterhouseCoopers study, commissioned by the European Commission, estimates Basel implementation costs for large banks to range between $98-$181 million. Thus, wherever possible, regulators should balance the proposal with simplifying assumptions appropriate for industry segments or particular circumstances. We note that the final version of Basel II takes such an approach for revolving credit exposures – one of the most difficult and complex sections in the proposal – and we urge that type of simplification also be applied to other aspects of the rule.

In particular, we believe that regulators should ensure that specialized banks with minimal credit risk positions do not need to take on all the modeling and related cost burdens appropriate to diversified banks with large credit risk. A more simple approach to CRBC is appropriate for specialized banks whose main activities are providing asset management, custody, payments processing and other "agency" type services.

Mellon and other institutions are currently working with the U.S. regulators on ways to address this concern. We appreciate their interest in a suitable CRBC framework for specialized banks, but we would urge Congress to ensure that the final U.S. rules do not impose an unnecessary regulatory burden.

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[4] *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, Securities and Exchange Commission, Final Rule, June 8, 2004.

Broader Revisions to the U. S. Capital Proposal

The advance notice of proposed rulemaking issued last year states that OR was implicit in the Basel I Accord, which included a "buffer" to account for OR and other non-credit risks. With an AMA approach, the ANPR says no such "buffer" is required because no implicit risks remain in the regulatory capital charge. Of course, interest-rate risk, liquidity risk and many other types of risk remain without a specific regulatory capital charge. We would refer to the "supervision-by-risk" framework rightly used by all of the agencies, and would note the many specified risks for which no Pillar 1 capital charge is proposed.[5] Many of these risks – interest-rate risk, of course, but also liquidity and foreign-exchange risk – are quantified daily, in sharp contrast to operational risk, but only OR is included as a new charge in the ANPR.

The agencies in fact appear to recognize that a "buffer" remains important because of the proposed retention of the unique U.S. leverage capital standards, as well as the use of 10% as the risk-based capital criterion for eligibility as a "well-capitalized" financial holding company or insured depository. These standards are anachronistic and should be abolished, especially if a Pillar 1 ORBC charge is retained. With these standards in place and a new ORBC charge mandated, the overall cost of the Basel rules rises so high as to create undue economic cost and unnecessary competitive damage. Given that U.S. banks – in sharp contrast to EU banks – compete every day against firms outside the bank capital rules in key lines of business, these costs are particularly inappropriate and excessively burdensome.

Chairman Greenspan has recently pointed to the problem of retaining the leverage standard as the new risk-based rules are implemented. At an April 20 hearing before the Senate Banking Committee, Sen. John Corzine questioned retaining the leverage rule because, he rightly said, it undermines the whole point of mirroring economic risk with regulatory capital. A flat percentage capital charge against assets regardless of risk – the leverage requirement – totally contradicts the whole point of the Basel II exercise. Chairman Greenspan said he thought the leverage ratio might be phased out over time. We think it should be phased out immediately, especially given the many floors imposed in the Basel II Accord that would significantly limit any benefit from the new rules and, therefore, any risks associated with an overly-aggressive drop in regulatory capital for low-risk assets.

Quite simply, the U.S. rules must drop the leverage standard and readjust the well-capitalized one to reflect the fact that some banks will in fact be very well capitalized at far different ratios than now apply. Failure to drop these arbitrary ratios – especially if the ORBC requirement remains in Pillar 1 – would seriously undermine the goals of the ANPR and the larger policy interests served by alignment of regulatory and economic capital.

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[5] *Comptroller's Handbook for Large Bank Supervision*, Office of the Comptroller of the Currency, May 2001.

Conclusion

In conclusion, Mellon again thanks the Committee for focusing on this important issue. While, as noted above, the ORBC charge poses serious concerns for institutions like Mellon, we are hopeful that the continued support of the Committee, as well as cooperation with our regulators will ensure that the final U.S. rules do not contain a regulatory capital charge for operational risk.

JPMorganChase

TESTIMONY OF
ADAM M. GILBERT, MANAGING DIRECTOR
JPMORGAN CHASE & CO.

THE NEW BASEL ACCORD:
PRIVATE SECTOR PERSPECTIVES

BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
JUNE 22, 2004

Introduction
Good morning, Chairman Bachus, Congressman Sanders, and members of the Subcommittee. My name is Adam Gilbert, Managing Director in the Credit Portfolio Group at JPMorgan Chase & Co. JPMorgan Chase & Co. is a U.S. based internationally active bank operating in more than 50 countries. We are currently in the process of merging with Bank One, the nation's sixth-largest bank holding company. Thank you for inviting me here to discuss the proposed revisions to the 1988 Basel Capital Accord, more commonly referred to as Basel II.

We commend the Committee's continued interest in Basel, which has been beneficial to the process and appreciate the unique opportunity to have a constructive dialogue concerning what we expect will be an improved framework for regulatory capital requirements. We also commend the Basel Committee, the US regulators and US financial institutions for the openness of the process and their role in developing the proposals.

Although there are a number of areas requiring further consideration, the proposals to date do a far better job of measuring risk than the rules they are intended to replace. Please allow me to begin with a summary of our view and conclude with areas we suggest warrant further review.

Basel II – Moving in the Right Direction
We strongly support the direction of Basel II. The three pillars of minimum capital requirements (Pillar 1), supervisory review of capital adequacy (Pillar 2), and market

discipline (Pillar 3) provide a solid framework in which to address safety and soundness issues in an environment of continuous innovation in the financial markets. The Committee's objectives with respect to Pillar 1 capital requirements – improving the way regulatory capital requirements reflect the underlying risks and incorporating advances in credit and operational risk measurement techniques – will address deficiencies related to the current regime and have the potential to promote stronger practices at internationally active banks. Today's capital rules treat all borrowers the same regardless of credit quality and do not address operational risk explicitly. Basel II will correct this.

Ultimately, a bank's risk profile is best captured using its full range of internal models. As an important step in that direction, we welcome the Advanced Internal Ratings approach (AIRB), which will permit banks to incorporate their own estimates of defaults and loss recovery rates into a formula calibrated by supervisors. We also welcome the Advanced Measurement Approach (AMA) for operational risk which directly leverages banks' risk measurement techniques.

Operational Risk

There has been considerable debate about the appropriateness of a Pillar 1 capital charge for operational risk. We are highly supportive of a Pillar 1 approach rather than a Pillar 2 approach, as some have suggested. A Pillar 2 approach would require banks to gather the same information as if they had a Pillar 1 charge yet there likely would be a loss of transparency and consistency in the methodology applied across the industry.

For about a year now we have had an internal operational risk capital charge in place which we believe is consistent with the AMA standards. We have this charge because we are fully cognizant that inadequate or failed systems, processes or people can result in losses to our firm. The information and control processes associated with our capital framework have already provided significant value to our business and risk managers. The science around operational risk measurement will continue to evolve. We believe that an explicit Pillar 1 charge and associated standards will be beneficial in this regard and will promote further discipline in banks' operations.

Room for Enhancements

In a few days the Basel Committee will release a revised version of its Capital Accord, reflecting comments from across the financial services industry. The new version of Basel II will incorporate positive changes related to the calibration of the overall capital requirement, the measurement of credit risk for wholesale and consumer businesses, as well as guidance on the practical application of the AMA.

We appreciate the fact that the Basel Committee has committed to continue work on several important issues that we believe necessitate further enhancements. These areas include the treatment of counterparty credit risk, hedges of credit risk and short-term exposures. There are several other issues which merit clarification or modification, but

these are largely technical in nature. Additional information can be found in our recent comment letters[1] or I would be happy to discuss these in greater detail during the Q&A.

To be sure, there is a lot for both banks and supervisors to do to prepare for the implementation of Basel II. A primary example is the qualifying process for the advanced approaches, which will be very burdensome unless there is close cooperation among supervisors. Home country supervisors must play the lead role to ensure that the process for qualifying is addressed at the consolidated level and that banks do not have to go through separate approval processes in every country in which they have a presence. We understand that some local requirements might be different for subsidiaries and possibly branches, but we expect the home supervisor to help bridge the gaps where necessary. We are confident the US supervisors will do just that.

Conclusion
Chairman, I would like to thank you and the Committee for the opportunity to speak on these issues. This concludes my remarks today. I will be happy to answer any questions you might have.

[1] Advanced Notice of Proposed Rulemaking Response (November 2003)
http://www.federalreserve.gov/SECRS/2003/November/20031105/R-1154/R-1154_34_1.pdf
Basel Committee's Third Consultative Paper Response (July 2003)
http://www.bis.org/bcbs/cp3/jpmorcha.pdf

SUNTRUST

Testimony of

Sandra W. Jansky
Executive Vice President & Chief Credit Officer
SunTrust Banks, Inc.

Before the

Financial Services Committee's
Subcommittee on Financial Institutions and Consumer Credit
Of the
U.S. House of Representatives

On

The New Basle Accord:
Private Sector Perspectives

June 22, 2004

INTRODUCTION:

Mr. Chairman and members of the committee, I am very pleased to have the opportunity to discuss SunTrust Banks' view of the proposed capital accord. I am Sandra W. Jansky, Executive Vice President and Chief Credit Officer for the company. I have been in the banking industry for thirty-four years, almost totally in lending and credit risk management functions. I have been employed with SunTrust Banks, Inc. for twenty-three years. My current responsibilities with the corporation include management of all aspects of credit risk for the company; that includes credit approval, credit policy and administration, workouts, credit risk rating methodology, credit analytics and management information reporting for credit risks as well as the credit review function. I am a member of the company's management committee, strategic integration committee and I chair the Basel II Steering Committee for compliance with the new accord. I also had the privilege of serving as the immediate past chairman of the Risk Management Association.

SunTrust Banks, Inc. (STI) is the seventh largest domestic bank in the US with assets of $125 billion. We have 1,201 offices located in eleven states from Maryland to Florida and we have approximately 27,000 employees. As of December 31, 2003 SunTrust had total assets under advisement of $181 billion that included $159 billion in trust assets and $22 billion in brokerage assets. Our loan portfolio is approximately $82 billion and our mortgage servicing portfolio is approximately $70 billion. SunTrust is considered by many of our peers, regulators and Wall Street analysts to be a conservative financial institution that has consistently demonstrated best in class asset quality since our inception.

In my comments today, I will address our reasons for choosing to become an "opt-in bank," our view of the positive aspects of the accord and issues that we continue to believe are problematic such as operational risk, commercial real estate treatment, treatment of home equity and disclosure requirements for Pillar III.

GENERAL POSITION:

The stated purpose of the New Accord is to more closely align the overall level of regulatory capital with the risks taken on by financial institutions. The goal is to require financial institutions to use industry best practices to measure, mitigate and manage risks. As a conservative financial institution we strongly embrace efforts that encourage banks to improve their risk management process.

Our financial institution believes it is imperative that we comply with the provisions of the Basel II accord. As a conservative risk taker we believe we have been required to hold excessive regulatory capital without true consideration for the composition of risk in our institution. If there is an opportunity to better align regulatory capital with the economic capital required by public markets, we want to be able to qualify for such treatment. Our belief is that lower risk banks should hold lower capital and higher risk banks more capital. That would allow regulators and others to distinguish the more conservative and predictable financial institutions from those that have somewhat volatile swings in performance due to higher risk profiles.

We believe we must move forward quickly to meet the requirements under the accord due to our size. We will be approximately $145 billion in assets by the end of third-quarter this year. Due to the complexity and vast requirements under the accord, it is impractical for our institution to delay compliance with the proposal. As the second largest Federal Reserve Board regulated institution in the country, we need to continue to pursue advanced risk management practices. We believe delays would

further increase our costs of compliance. We also believe we could be at a competitive disadvantage compared to "core banks" if they are able to operate with lower capital levels than SunTrust. This impacts our cost to deliver credit products in the market and the overall risk adjusted returns of those products. As you know, financial institutions with assets in excess of $250 billion and/or international assets in excess of $10 billion are defined as "core banks" by the U.S. regulators. SunTrust Banks is an "opt-in bank" which has made our efforts to meet the accord requirements challenging. As an "opt-in bank" we are not at the table with the core banks and senior regulators as issues are explored and recommendations made on a wide variety of issues. Additionally, core banks have the advantage of more focused regulatory assistance as they pursue the Advanced Internal Ratings Based (AIRB) status. "Opt-in banks" need additional guidance and assistance from the regulators that is not readily available today.

The most significant feature of the proposed accord for STI has been the introduction of a two-dimensional risk rating system. We began development of a two-dimensional risk rating system in 1999. We will complete our final rollout of the system, known in our company as PRISM, by the end of this year. We have seen enormous benefit not only in the risk management areas of the company but also in our lines of business. This more robust risk rating system has allowed us to develop a much more detailed understanding of the risks in our portfolio across all lines of business. We have trained numerous employees on the concepts of obligor rating (probability of default) and facility rating (loss given default). This has led to the development of better pricing models in our institution and a better understanding of the risk/return opportunities in our marketplace. We see tremendous possibilities with the new ratings methodology.

We believe the two-dimensional risk rating system, transparency of the risk rating system, data maintenance and model validation aspects of the accord are all positive. I would hasten to add that these have been implemented at considerable costs to our financial institution and there will be significant costs built into our ongoing budget processes to maintain the rigor of the process.

TECHNICAL ISSUES:

As much as we like certain aspects of the accord, the overly prescriptive requirements as well as level of complexity will continue to challenge us as we continue to move towards Advanced Internal Ratings Based status. We continue to remain concerned about the special treatment provisions required for certain specialized lending areas such as commercial real estate. While some change has been announced to the original proposal, we believe that the higher capital requirements for certain asset types without regard for the specific risk management practices of a particular institution remain problematic. We have yet to see empirical evidence that would support the proposed higher requirements for certain classes of commercial real estate. With arbitrary capital minimums established for certain product types, the loans may not make the required return rates (internal hurdle rates) to satisfy profitability return requirements. This could lead to less supply for this type of credit by financial institutions. Simply put credits that the regulators delineate as higher risk might become too costly for banks to provide. This could lead to more volatility in the availability of credit to support construction and development projects in various markets across the United States. Again, SunTrust is a very conservative underwriter not only in credit origination but also in the ongoing monitoring of risks inherent in credit extended.

We are also concerned about the correlation requirements for residential real estate and home equity lines and loans vs. credit card portfolios. Home Equity Lines of Credit (HELOCs) that are required to be treated as exposures backed by residential mortgage are subject to a minimum LGD of 10% and an asset correlation of 15%. Credit cards have a (very low) 4% correlation. These asset correlations are to be used regardless of the quality of the individual credits. The proposed treatments will impact the costs of credit availability to product lines that have grown tremendously over the last ten years. Home equity lines and loans have provided very affordable access to credit for millions of consumers. The correlation requirements proposed could result in higher capital to secured equity products than unsecured credit card products. Again, there is no distinction between the risk management, underwriting and mitigants used by different institutions. Our actual loss experience in these products is significantly below the minimum requirements.

OPERATIONAL RISK:
Of all the changes required for advanced status under Basel II, the most significant is in the quantification of operational risk. Operational risk quantification has been largely rule of thumb without the accuracy of market or credit risk quantification. Though there has been improvement in the field since the first release of the accord, operational risk quantification is still far behind the other two and it will take some time to bridge that gap. This is highlighted by the lack of guidance in Basel II documentation and the ANPR in the area of operational risk quantification. While we understand the challenges the regulators face in providing meaningful guidance, it is a significant concern that we are this close to the implementation date and there is no widely accepted approach to estimating operational risk capital. Given the amount of set-up time required to accurately make these estimates, both in terms of data requirements (and the need for long time series of data) and the development of institutional knowledge, this places banks in a very difficult position.

The Federal Reserve has taken the position that the Advanced Measurement Approach (AMA) is the only acceptable approach to calculating operational risk regulatory capital and is therefore required if a banks wants to the use the Advanced Internal Ratings Based approach to credit capital. While we understand their argument that the Basic and Standardized approaches are not accurate, we believe this might place the American banking industry at a competitive disadvantage. If we at SunTrust can satisfy the requirement for the Advanced Internal Ratings Based approach for credit risk and fail to meet the currently unspecified requirements for Advanced Measurement Approach for operational risk, we will be forced to use the current approach (Basel I) for both credit and operational risk.

A similar bank in another country would have the ability to use the AIRB approach for credit risk and the Basic or Standardized approach for operational risk. We believe this represents a potential disadvantage to U.S. banks working diligently to comply with the operational risk requirements of the accord. Given the crude nature of the development of operational risk quantification, holding credit risk hostage to operational risk seems a significant mistake. If a bank is able to show that it is in the process of implementing a sound operational risk management system, it should be allowed to use the Advanced Internal Ratings Based (AIRB) for credit, and for a temporary period, use the Basic or Standardized approach to operational risk.

DISCLOSURE REQUIREMENTS:
The disclosure requirements of Pillar III seek to enhance market discipline through increased public disclosure. In our 2003 annual report we provided thirty-eight pages of additional disclosure addressing all aspects of risk in our institution. Our annual report including all the required financial and regulatory disclosure is now 100 pages in length. While transparency and disclosure are admirable goals, the Pillar III proposals will add a substantial amount of very technical disclosures that we believe will be difficult for readers to comprehend. The requirements are specific to provide a regulatory view of risk. We are very concerned not only about the prescriptiveness of the required disclosures but also the fact it does not provide the flexibility necessary to make adjustments as risk management practices evolve.

SUMMARY & RECOMMENDATIONS:
SunTrust Banks, Inc. believes the new accord is a very positive step in the right direction. We commend the regulators, members of this committee and the International committee for the progress that has been made to date. We do believe the U.S. regulators should consider the following recommendations:

1. Establish a working group of the "opt-in banks" to further enhance the ability of those banks that have committed substantial human capital and financial resources to meet compliance with the accord. These banks are getting too little assistance today so the regulators can guarantee compliance by the "core banks."

2. U.S. regulators should allow banks to qualify for the Advanced Internal Ratings Based capital approach for credit risk and allow operational risk requirements to be met under the Basic or Standardized approach to be utilized in non-U.S. countries. There would be substantial incentive for the U.S. banks to work to comply with the advanced status for operational risk while giving them sufficient time to thoroughly implement the program requirements.

3. Asset correlations assigned to certain consumer products need to be revisited to make sure they make sense as you look at the risk issues associated with like products. The asset correlations proposed appear to be inconsistent. Or, an alternative would be to let us treat Home Equity Lines of Credit (HELOCs) as Qualifying Revolving Retail Exposure (QRRE).

4. Address the complexity and magnitude of additional technical disclosures required under Pillar III.

Thank you for the opportunity to present our issues and views around the proposed capital accord.

APPENDIX:

SECURITIZATION:

While correct conceptually, the differentiation in the higher credit grades (AAA and AA) is not meaningful. It is not until the exposures become A or worse that the resulting risk weights are meaningful.

Currently, many investors do not have the information required to calculate underlying exposures, as they are not readily available in the servicing reports. Since N is relatively easy to calculate, with access to the information, it should be simple enough for servicers to provide the calculation in most deals. Vendor analytics programs can supply the necessary information to calculate information internally for most, but not all, deals.

The securitizations have performed well in the risk ratings purchased by SunTrust. We feel comfortable that rating agencies know how to structure the securitizations appropriately. Recent events, however, have sensitized the market to the general issues of operational and servicer risk associated with these transactions; these risks are difficult to separate from the performance of the structure and the underlying collateral, as they are so often entwined. Defined as Credit Risk in the ANPR, the inherent risks associated with the credit of the servicers (fraud, solvency, and collections) is not always reflected in the rating in a timely fashion as the servicer deteriorates financially.

OPERATIONAL RISK: COMPETITIVE EQUITY

The implementing bodies in the United States should allow banks with a well-developed implementation plan for the Advanced Measurement Approach (AMA) for measuring operational risk capital to use the Advanced Internal Ratings Based approach to measure credit risk capital until completion of this plan.

A significant difference between the American implementation of the new Basel Capital Accord (New Accord) and that of other nations as outlined in the ANPR is the elimination of two potential approaches to measure minimum levels of operational risk capital, the basic indicator approach (BIA) and the standardized approach (see section 1C of Attachment 1). This difference is important due to the broad approach of the A-IRB. Under the A-IRB, minimum regulatory capital is derived solely from the credit risk of the underlying exposures, with no "gross-up" for operational risk (as exists under the current framework). As a result, for a bank to use the A-IRB, it is necessary that it also have a mechanism for calculating minimum levels of operational risk capital. The New Accord approaches this problem by giving banks a menu of possible approaches to calculating operational risk capital, from the exceedingly simple (the BIA) to the complex (the AMA). In the ANPR, American banks are restricted to using the AMA. Though we understand the rationale for this choice, we strongly disagree with it, and would like to offer an alternative proposal.

SunTrust's concern lies ultimately on the varying levels of development of quantitative, capital-based risk management methodologies in the areas of credit and operational risk. Quantitative credit risk management is a well-developed field, with widely agreed upon methodologies and the general opinion that, even if not immediately available to all institutions, adequate data is obtainable to accurately parameterize the models used to estimate the tail events that drive capital levels. By 2007, a bank that started developing a modern credit risk ratings system following the initial Consultative Paper of the

New Accord should have adequate systems, models, and data to allow for the implementation of the A-IRB.

A similar level of development does not exist in the area of Operational Risk Management (ORM). ORM is a new field, and the basic questions as to the best approaches for issues such as capital measurement have not been agreed upon. For example, the relative value of internal data vs. external data vs. "scenario analysis", and methodologies for converting external data into something usable internally, are undecided.

This disparity in development places institutions, and regulators, in an awkward position. Banks are concerned that their investments in measuring credit risk will not fully pay off, as they will be denied A-IRB status because they have not yet achieved AMA status. Regulators are forced to emphasize development of an untested operational risk methodology. We believe the following proposal largely eliminates these problems without giving up the benefits that are associated with implementing the AMA.

Regulators should allow banks to use the A-IRB approach to estimate credit risk capital and use the BIA or the standardized approach to calculate operational risk regulatory capital as long as the following conditions are met:

a) The bank is in compliance with all areas under the titles "Corporate Governance" and "Operational Risk Management Elements", as specified by the Supervisory Guidance on Operational Risk/Advanced Measurement Approaches for Regulatory Capital
b) The bank has an implementation plan for the AMA that has well-developed and transparent milestones
c) The bank is capturing internal operational risk data, and effectively using internal data, external data, business environment and internal control factor assessments, and scenario analysis in the management of operational risk throughout the bank

By meeting these conditions, the bank shows that it has a well-developed approach to measuring and managing operational risk, which should be the primary goal of the regulation. It is reasonable on the part of the bank to expect to be recognized for these efforts by the regulatory bodies by gaining access to the new regulatory regime, and by recognizing such efforts the regulators create a system of incentives that would lead to a reduction in operational risk system-wide.

We understand that the BIA and standardized approaches are not accurate measures of operational risk, and used continuously could lead to very poor sets of incentives. This is why we support only temporary use of these measures. For a period of a few years, with a clear end point, the benefits that arise from using the A-IRB far outweigh the negatives associated with the BIA and standardized approach.

Our proposal bears consideration for the following reasons:
Competitiveness of the American banking industry: We strongly support the basic philosophy behind the New Accord: capital should be aligned to risk, and the models actually used by the banks best measure this risk. We believe that the New Accord will improve the efficiency and competitiveness of banks that can use the advanced approaches to measuring risk, by incenting them to take on economical risks, and

rewarding (or punishing) them for the actual risk associated with their decisions. In our opinion, banks that are permitted to use, in particular, the A-IRB approach will be at a genuine competitive advantage to those that will not, and a banking system consisting of said institutions will be both more profitable and more stable.

The current state of regulatory capital measurement leads to an inevitable split between economic and regulatory capital management. This results in a conflict between the regulators and the shareholders, and banks perform a wide variety of convolutions to balance the demands of the two, resulting in decreased profitability and increased instability of the system. The A-IRB approach to measuring regulatory capital will go a long way towards alleviating this problem. Banks using the approach will achieve consistency between their economic and regulatory capital measures. The benefits are significant. By aligning the interests of shareholders and regulators, there will no longer be a conflict between maximizing profits and maximizing stability.

By eliminating the option of all non-AMA approaches to measuring operational risks, American regulators run the risk of holding the A-IRB, and its widespread benefits, hostage to a poorly understood approach to measuring operational risk capital. This would create a system that disadvantages American banks by continuing the split between internal and external measures of risk, resulting in a banking system that is both less profitable and less stable then those in other nations. We do not think this is a desirable goal.

FINANCIAL DISCLOSURE:

SunTrust is concerned with the quantitative disclosure in two respects. The first is that enhanced disclosure does not translate into improved transparency; due to the complexity of the underlying theory and the Accord itself, these disclosures have the potential to be read by few and understood by even less.

The second deals with the matter of proprietary information regarding the nature of specific portfolios and the potential to provide competitors with more meaningful information than our investors and creditors. As competitors, we follow each other's loan pricing closely. With sufficient granularity of portfolios in the reports and the necessary quantitative metrics, we understand each others' businesses well enough that it would be possible to reverse engineer the assumptions underlying the pricing models, in particular, the perspective of credit risk for particular asset class.

To assuage these concerns, we would propose that a working group be formed, comprised equally of bank representatives, unaffiliated analysts, rating agencies, and regulators to create a standard reporting format. The objective would be to provide meaningful statistical information that can be used by readers to understand the capital levels, as well as their changes from period to period. The information should be sufficient to meet their needs, while not compromising proprietary pricing strategies and practices. The latter two of the working group - regulators and rating agencies - could potentially receive a more detailed schedule of the public summary.

Use of the Advanced Internal Ratings Based approach for credit risk will increase the current time required preparing the Call Report and the FRY9-C. The new disclosure requirements conflict with the initiative to shorten the filing deadlines for these reports.

While it seems that the Annual Report would be a good vehicle for required disclosures, the volume of additional disclosures would add multiple pages to bank's reports that are already in excess of 100 pages and do not serve as easily interpretable shareholder information. We do not think creating a separate document is the answer either. Preferable would be a new page added to the FRY-9C that would disclose sections (a) and (b) from Table 6 from the Basel Third Pillar. This would verify whether the bank's regulatory supervisors had approved the ratings approach and would briefly describe the ratings system. We believe the remainder of table 6 detailing the internal rating system would not add value to the market participant's decisions. For the details we believe the market participants can rely on the supervisory validation.

We feel the SEC's rules for Management Discussion and Analysis would require SunTrust to discuss the bank's approach to assessing the adequacy of capital to support current and future activities, including SunTrust's approach under Basel to assess and manage risk. If the regulators believe the SEC's rules regarding MD&A would not satisfy the disclosures as prescribed by Basel, then additional guidance would be needed.

The requirement to describe the entities comprising a company's consolidated banking group does not give enough guidance. This list for all large banks would be extensive and overwhelming. We suggest limiting the list by using only those entities that meet a designated percentage of total assets or income.

Testimony of

America's Community Bankers

on

"The New Basel Accord: Private Sector Perspectives"

before the

Subcommittee on Financial Institutions
and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

on

June 22, 2004

Kathleen E. Marinangel
Chairman, President & CEO
McHenry Savings Bank
McHenry, Illinois
and
Member, Board of Directors
America's Community Bankers
Washington, DC

Mr. Chairman, Ranking Member Sanders, and members of the Subcommittee, my name is Kathleen M. Marinangel. I am Chairman, President and Chief Executive Officer of McHenry Savings Bank, a $210 million institution in McHenry, Illinois. The primary business lines of the bank are focused on the retail customer and a significant portion of the assets of the bank is single-family mortgages. For reasons that I will describe later, in the last decade our business strategy required that we invest in a more diversified mix of assets, including adjustable commercial real estate and consumer loans. These products can be repriced more frequently and flexibly to take account of interest rate swings.

I am testifying today on behalf of America's Community Bankers, where I serve as a member of the Board. I also serve on several committees and on the Basel II Working Group. Thank you for this opportunity to testify on the impact that the Basel II Accord will have on community banks from a competitive perspective, as well as what effect the Accord will have on consolidation and merger activity in the financial services sector. I believe that the development and implementation of the Basel II Accord is one of the most important regulatory initiatives for community banks today. However the banking regulators in the United States craft requirements for insured depositories in the United States, the result will impact capital levels and what is necessary to measure capital. The business of every community bank will change in some way as a result of the Basel II Accord.

In the years since the adoption of the Basel I Accord, the ability of all financial institutions to measure risk more accurately has improved exponentially. That ability to measure credit, interest rate, operations, market and other risks is the basis for the changes that will be part of the revised capital requirements. Unfortunately the complexity and cost of development, implementation and supervision of the models needed to measure and evaluate the risks likely will preclude all but a small number of banks in the United States from taking advantage of the more risk sensitive capital regime. As currently contemplated, only about 10 banks in the United States would be required to comply with Basel II. An additional 10 to 15 believe that they have the resources to voluntarily comply.

I think that is a shame. My perspective is that of a CEO of a small community bank that does not currently have the resources to voluntarily opt in to Basel II's advanced internal ratings-based formula for determining capital levels. Under the current proposal, my institution would remain subject to Basel I. If it were economically feasible, I would strongly recommend that my bank "opt-in" to Basel II. In fact, ACB believes that any financial institution that has the resources should be able to opt into Basel II if its management and the Board believe it is in the institution's best interests. There should not be any constraints on which institutions have the choice to opt in.

An alternative that ACB has advocated in its letters to the banking regulators is that the current capital regime which is based on Basel I should be amended to take advantage of the ability of institutions and supervisors to measure risk more accurately and make changes to the current capital requirements. The purpose of these changes would be to alleviate some of the disadvantages for community banks and more accurately reflect each bank's actual risk levels that ACB and others believe will develop with the implementation of Basel II for the largest

banks. In fact, the federal banking agencies announced just last week that they have decided to do just that. They have indicated that resources have been earmarked for a project that will propose revisions to the current risk based capital requirements.

Before I address some of ACB's concerns with the Basel II Accord in more detail, I would like to describe why the implementation of the capital requirements and risk management is important to me as a community banker. While there are a number of risks involved in determining risk based capital, an important one is interest rate risk. Because of the interest rate volatility in the past 25 years, many community bankers have had to develop strategies to manage the risk that include changing their business model.

To better understand my position on the importance of the ability to accurately allocate risk for capital purposes, let me give you some background on my bank's history. McHenry Savings Bank is a survivor of the high interest rate cycle of the late 1970's and early 1980's. At that time, the bank's assets were primarily 25-year, fixed-rate mortgage loans. Liability rates rose to historically high levels in the range of 18 percent while the mortgage loans held in portfolio maintained an average yield of less than eight percent. Management of the bank was aware that the inability to reprice assets was an important cause of the failure of many banks. While the credit risk of mortgage loans was and continues to be low, the interest rate risk of that same mortgage portfolio is very high.

The management and board of McHenry Savings Bank adopted a strategic plan that included a goal to diversify assets in such a way that the bank would never again rely on one type of asset in its loan portfolio. An important factor in developing this strategy was that the bank has the ability to reprice those assets as often as possible. Management and the board of the Bank realized that flexibility in repricing was a key to survival in times of fluctuating interest rates. For several years, the bank repriced 80 percent of its assets annually. The portfolio mix that we decided was optimal ultimately consisted of consumer loans equal to 25 percent of assets, commercial loans and commercial real estate loans equal to 20 percent of assets and the rest and of the portfolio is shorter duration mortgage loans and investments. Because commercial loans floated daily with prime rate and one-third of the consumer loans repriced annually, we knew that portfolio interest rate risk was minimized.

Shortly after completing the restructuring our portfolio, in 1988, the Basel Committee on Banking Supervision implemented the Basel I Accord. This risk-based capital formula created a standardized system for risk weighting of assets. Management of McHenry Savings soon realized that as a result of the restructuring of assets the bank did not meet the risk-weighted requirements adopted by the federal banking regulators to implement Basel I. Unfortunately, the simplicity of the formula did not enable banks to determine the true risk of assets. No consideration was given to collateral value or loan-to-value of assets. From the beginning, a more diverse formula was needed. A number of minor changes have been made over time, but the general requirements are the same today as they were when first adopted. Moreover, advances in risk management techniques have magnified the inadequacy of the Basel I formula.

I personally have sent letters to over two thousand bankers, regulators and legislators over the

years asking for modifications to this formula to more truly reflect the risk of assets held in portfolio. The current system requires banks to carry far more capital than they need, because it fails to consider such factors as the loan-to-value ratio of retained mortgage portfolios, collateralization of commercial loans, and banks' significant nonfinancial assets. More than the current four buckets are necessary and consideration must be given to collateral values and loan-to-value ratios. These are examples of elements of risk measurement that will be available to the banks that comply with Basel II, while the vast majority of US banks will have to comply with the current crude risk measurement, unless Basel I is amended.

Now that some large U. S. banks and international banks will have the ability to adopt the new Basel II Accord, it is time to address the shortcomings of the Basel I risk-based formula by which the community banks will have to abide. Without change, many community banks will be required to hold capital under the current capital requirements that is higher than that of more risky institutions.

Currently, a mortgage loan with a 20 percent loan-to-value ratio is risk weighted the same as a mortgage loan with a 90 percent loan-to-value ratio. It is clear that the risk is not the same. Bank buildings are currently weighted at 100 percent, thereby giving no value to this strong asset. More examples are illustrated in Appendix A as attached.

The formula assumes that fixed rate mortgage loans are less risky than commercial real estate loans. Mortgage loans are weighted 50 percent while commercial loans are weighted 100 percent. The credit risk of a fixed rate mortgage loan may be less than the credit risk of a commercial loan, but the interest rate risk of the mortgage loan will be higher than an adjustable rate commercial loan, particularly in today's new rising rate environment. Just as in the late 1970's, in a rising rate environment, fixed rate mortgages will not reprice and the duration of the loans will lengthen. The current formula does not address this interest rate risk.

Basel II Accord

With that background, let me turn to a discussion of the Basel II Accord and ACB's concerns and position. ACB does not oppose implementation of Basel II. We support the efforts of U.S. and global bank supervisors to more closely link minimum capital requirements with an institution's risk profile. This approach could increase the safety and soundness of the banking industry and allow institutions to deploy capital more efficiently.

We do have concerns about the complexity of the proposal and the ability of financial institutions to understand and implement, and supervisors to adequately administer and enforce, the proposed new capital requirements. Although the most recent version of Basel II is less detailed than previous versions, it remains an extremely complex document. Because adequate capital is so important to the global financial community, the inability to properly implement, supervise and enforce capital requirements can lead to significant safety and soundness issues.

Therefore, we believe that legislators, regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance prior to implementation. More

examination needs to be made into the real-world consequences of adopting an extremely complicated capital regime, including the resources needed for implementation, the problems inherent in on-going maintenance, the likelihood of effective regulation and market oversight, and the competitive pressures that could encourage banks to game the system.

We are pleased that the U.S. regulators have proposed to leave a leverage requirement in place. While there may be some legitimate dispute about the proper level of that requirement, a regulatory capital floor should remain in place to mitigate the imprecision inherent in internal ratings-based systems. I will address later in my testimony the impact that the complexity of the proposal has on the ability of a community bank to opt in to the proposal.

Competitive Concerns

A new capital accord should treat similar risks comparably from institution to institution to avoid creating competitive inequities. The most recent quantitative impact study conducted by the Basel Committee on Banking Supervision shows that the new accord could result in significant capital savings for some of the largest banks and savings associations in the United States and other countries. While the study was based on incomplete information, it does give us a preliminary look at what the impact of Basel II could be. The study shows that institutions that can use an internal ratings-based approach to determine capital and that have primarily a retail portfolio may see their minimum capital requirements reduced significantly. These same large banks compete head to head with community banks in the retail area. Retail lending, particularly residential mortgage lending, is the fundamental business of community banks.

We understand that the U.S. bank regulators intend to conduct their own quantitative impact study, and we will be interested in seeing the approach that the study will take. We also are pleased that the Federal Reserve Board is now utilizing resources to review and analyze the competitive effects of a bifurcated capital system on several different product lines as well as on merger and acquisition activity. The Federal Reserve has completed its study on the small- and medium-size business loan market and on the impact of the proposal on further industry consolidation. While we do not necessarily agree with the conclusions of the studies, we appreciate the efforts being extended and will look forward to seeing the Federal Reserve's planned study on the mortgage product line. We also are retaining our own experts to more carefully review the Federal Reserve studies and separately analyze the competitive impact of Basel II.

While nobody can say with certainty at this time what the impact of a bifurcated system will be, one can assume that it will open the door to competitive inequities. Under that system, two different banks, a larger Basel II bank and a small Basel I community bank, could review the same mortgage loan application that presents the same level of credit risk. However, the larger bank would have to hold significantly less capital than the small bank if it makes that loan, even though the loan would be no more or less risky than if the community bank made the loan. Because we believe that capital requirements play a part in the pricing of loan products, that community bank may not be able to offer that borrower the same competitive interest rate that can be offered by the larger institution. This cannot be the right result or the desired result.

Capital requirements should be a function of risk taken and if two banks have very similar loans, they should have a very similar required capital charge. Although some community banks may choose to have capital levels higher than required by regulation, that is a choice that might be made for various legitimate reasons, and is not a justification for leaving in place higher capital requirements for the same types of lending.

We are concerned that unless Basel I is revised, smaller institutions under a bifurcated capital regime will become takeover targets for institutions that can deploy capital more efficiently under Basel II. For instance, if I could acquire another bank's assets at a fraction of the required capital ratio imposed on that bank, I would surely do so. What was required capital at the acquired bank would be excess capital if I had a lower capital requirement, the equivalent of printing money from my perspective. The bifurcated capital structure would drive acquisitions that otherwise would have no economic purpose. Another important factor for publicly held community banks is the need for them to leverage their capital to maintain a sufficiently high return on assets for their shareholders in order for them to remain independent. And, the smaller banks that survive as stand-alone entities will find it more costly to compete for quality assets and may be forced to operate with less capital in order to provide more competitive pricing.

The competitive effects discussed above are exacerbated by the current "all or nothing" approach to the proposed implementation in the Untied States. Institutions opting in to the new accord not only must implement the complex and expensive internal ratings-based approach, but also must do so across all asset classes in order to realize even the most obvious benefits of the new accord. Also, if an institution cannot meet the significant burden of adopting both the internal ratings-based approach to calculating credit risk and the advanced measurement approach to measuring operational risk, there is no ability at all to align capital more closely with balance sheet risk.

Community banks must retain the option to leverage their capital, regardless of the complexity of the calculations, to improve their ability to manage risk. Whether the choice is to implement Basel II or a revised, more risk sensitive Basel I, community banks must be given the opportunity to compete against the international banking giants. These large banks have branches in many communities across the country, and compete directly with community banks.

ACB does not believe that the new accord should be implemented in the United Statues until more information is gathered and analyzed about the competitive effects. If studies show that smaller banks will be harmed competitively, steps need to be taken to address the inequity, including making changes to Basel I and making it easier for smaller banks to opt in to Basel II. Otherwise, these inequities will only add to the other disadvantages under which community banks operate and threaten the ability of community banks to survive.

Alternative Proposals

If Basel II is implemented for a portion of the banking industry, changes must be made at the same time to Basel I to maintain similar capital requirements for similar risks. One approach would be to revise the current accord to make it more risk-sensitive for all institutions, and then add more complexity to capture any additional risk at more complex and sophisticated

institutions. A revised Basel I could include more baskets and a breakdown of particular assets into multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit mitigation measures, such as mortgage insurance and guarantees, could be incorporated into the framework and other revisions could be made to further refine current capital requirements. One example of how assets could be treated under a more refined Basel I is set forth in Appendix A. The approach would be relatively simple for banks to implement and for regulators to supervise. This example is just one approach. Any effort to refine Basel I for all institutions should be a collaborative effort between banking supervisors and the banking industry. There is still time to proceed in this direction before Basel II is implemented at the end of 2007.

Another option would be to give more U.S. financial institutions the proper incentives to continue to improve risk management practices and thereby reap the benefits of more risk-sensitive capital requirements. My institution and many other community banks would like the opportunity to improve their risk management practices to such a degree that we can use our internal assessment of risk to determine adequate capital levels. ACB believes that the complexity of Basel II and the significant obstacles to opting in to benefit from more risk-sensitive capital requirements are not warranted. Most community banks simply do not have the resources necessary to meet the significant eligibility standards proposed in Basel II for adopting an internal ratings-based approach for assessing capital, nor do they have a business model that would make the costs associated with developing a system for such an approach reasonable.

Safety and soundness of the banking system can be increased by providing incentives to a greater number of institutions to improve their risk management systems. This can be done by allowing U.S. banks and savings associations to adopt the standardized approach in the new accord that will be available in other countries. Also, the conditions for opting in to the more advanced internal ratings-based approach could be made less burdensome and the approach could be simplified to make it a more viable prospect for smaller institutions. Additionally, ACB has asked the U.S. regulators to address the ability of smaller institution to use third party vendors, consortiums, or other joint approaches in meeting the conditions for opting in to the new accord. It is likely that products and services will become available to assist institutions in obtaining the necessary data and establishing the necessary infrastructure to develop an internal ratings-based approach.

Conclusion

In conclusion, ACB does not oppose the implementation of Basel II in the United States. We believe, however, that more examination has to be given of the ability to implement the proposal adequately and the competitive impact of a bifurcated capital system. Revisions to Basel I must be made to recognize the lower level of risk of retail loan products (particularly mortgage loans), more accurately reflect the true risks in community bank portfolios, and lessen the unintended competitive impact of Basel II. We thank Chairman Bachus and the rest of the Subcommittee members in giving us this opportunity to present our views. As I mentioned at the outset, there is no more important issue to community banks than the development and implementation of Basel II, as well as long overdue changes in Basel I requirements.

Appendix A

RISK-BASED CAPITAL
PROPOSED FORMULA

0% Risk Weight Category
- Cash on Hand
- U.S. Treasuries
- * **Interest-Earning Deposits (CD's) ≤ $100,000**

20% Risk Weight Category
- Cash Items
- Correspondent Banks
- Fed Funds Sold
- FHLB Stock
- General Obligation Municipal Investments
- Loans Secured By Deposits
- Money Market Fund Investments
- Municipal Loans
- U.S. Agencies
- U.S. Agency-Issued MBS's
- * **Interest-Earning Deposits (CD's) > $100,000**
- * **1-4 Family First Mortgages with LTV Ratio < 60%**
- * **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio ≤ 60%**
- * **Commercial Mortgages with LTV Ratio < 20%**
- * **Consumer Loans with LTV Ratio < 25%**
- * **Bank Land & Premises - 50% of Appraisal Value**

40% Risk Weight Category
- * **1-4 Family First Mortgages with LTV Ratio > 60% and < 75%**
- * **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio > 60% and ≤ 75%**
- * **Commercial Mortgages with LTV Ratio ≤ 40%**

50% Risk Weight Category
- Other Qualifying Junior Liens
- Private-Issue MBS's
- Qualifying Construction Loans
- Revenue Bond Municipal Investments
- * **1-4 Family First Mortgages with LTV Ratio > 75%**
- * **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio > 75%**
- * **Commercial Mortgages with LTV Ratio < 50%**
- * **Consumer Loans with LTV Ratio > 25% and < 60%**
- * **Commercial Loans with LTV Ratio ≤ 40%**

60% Risk Weight Category
- * **Commercial Mortgages with LTV Ratio ≤ 60%**

80% Risk Weight Category
- * **Commercial Mortgages with LTV Ratio ≤ 80%**

100% Risk Weight Category
- Allowance for Loan & Lease Losses
- Corporate Bond Investments
- Loans Past Due 90+ Days
- All Other Assets
- * **Commercial Mortgages with LTV Ratio > 80%**
- * **Consumer Loans with LTV Ratio > 60%**
- * **Commercial Loans with LTV Ratio > 40%**
- * **Bank Land & Premises - 50% of Appraisal Value**
- * **Unsecured Loans**

Off-Balance Sheet Items (20% Risk Weight)
- Letters of Credit (Cash Collateral)
- Letters of Credit (Other Collateral)

Total Adjusted Assets

Items notated with a * (and in bold type) "proposed".